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1 Introduction -- What is Estate Planning

We can begin to answer that question by defining the terms within that phrase. An ESTATE consists of the property and possessions of an individual (or group of individuals, or any legal entity, such as a corporation). PLANNING is defined in WEBSTERS NEW WORLD DICTIONARY (Simon and Schuster, Inc., New York, NY 1990) as A1. to make a plan of; 2. to devise a scheme for doing; 3. to have in mind as a project or purpose.

We include all three definitions of planning because, though basically the same, they do differ slightly. To make a plan, as definition No. 1. above suggests, does not necessarily mean it can be, or will be, carried out. To devise a scheme for doing implies that the plan will be actively followed, while definition No. 3. makes planning goal or purpose oriented.

When we think about these three slightly different definitions of planning in regard to estate planning, several thoughts come to mind.

- ◆ **First** of all, a plan must be made.
- ◆ **Second**, a way of implementing that plan must be determined.
- ◆ **Third**, the overall purpose of the plan must be kept in mind at all times.

The PLAN starts with a determination of exactly what property may be included in the estate. The type of property, the degree of ownership, and property value are all important.

Although the property may seem to be the most valuable element in estate planning, actually, it is how the property is used which is more important. In order to determine what uses property should be put we must ask very specific questions, questions having to do with the short-term and long-term needs of beneficiaries/survivors; questions having to do with the conservation of property both during the lifetime of the property owner and after his or her death; questions having to do with tax exposures; questions having to do with available means of disposing or dispersing property and/or its yield.

Thus, the PLAN becomes extremely important. If the plan does not use available property and income in the most effective way, then the needs of the estate owner and his or her survivors/beneficiaries will not be appropriately met (no matter what the value of the property).

It is for this reason that education in estate planning is so essential. Estate planning is not simply a matter of making a list of property, a list of needs, and then matching the two. Estate planning challenges the professional to consider a piece of property in various ways--as having current value, future value, income-producing value; as being liable for this tax and/or that tax; as being suitable for this type of conservation device or that one. Estate planning also challenges the professional to look at the needs of survivors/beneficiaries in various ways--immediate needs, ongoing needs, long-term needs, and contingent needs. Far from being a static, one-time occurrence, estate planning is a process with checkpoints for review, and with ample flexibility for change as property values and needs change.

The purpose of this course is to help insurance professionals in this challenging field. The material is divided into eight units:

1. Evaluating the Estate
2. Establishing Priorities
3. Wills
4. Using Trusts
5. Insurance Trusts
6. Other Estate Planning Devices
7. Gifts
8. The Estate Plan

Within each unit you will find detailed information about the topic, examples to illustrate information, and review questions to reinforce your knowledge and understanding of the concepts and data presented.

1.1 Terms used in this section

Before beginning Unit One, review these terms, which will be used throughout the course.

BENEFICIARY: anyone receiving or named to receive benefits, as from a will or insurance policy.

CONSERVATION DEVICE: A plan through which property in an estate is managed so that it is not wasted, or depleted by unnecessary expenditures.

CONTINGENT: dependent on or upon an uncertainty, as in a will. Beneficiaries will receive their inheritance CONTINGENT upon the decease of the maker of the will.

CURRENT VALUE: the commonly accepted value; value at the present time.

DISPERSE: to break up the property.

DISPOSE: to settle the property; to get rid of it; to sell it.

FUTURE VALUE: anticipated value of property according to some accepted economic determiner/standard--COST OF LIVING INDEX, INFLATION INDEX, etc.

INCOME-PRODUCING VALUE: the amount of income property does produce or can be expected to produce, also according to some accepted economic determiner/standard.

IMMEDIATE NEEDS: those needs which do exist or will exist at the time at which the estate plan becomes active; could be at the death of the estate owner, or at some predetermined date.

LONG-TERM NEEDS: those needs which do not exist now, but which can reasonably be expected to arise in the future (For example- long-term nursing care for a beneficiary or college education for minor children).

ONGOING NEEDS: those needs which are constant into the future, for example, living expenses for a family.

SHORT-TERM NEEDS: those needs with a definite time limit; for example, payments on a mortgage.

SURVIVOR: the legally-determined recipient of certain benefits. A SURVIVOR differs from a BENEFICIARY in that a beneficiary is chosen by the insured, or by the person making the will. A survivor received benefits because of a law granting them. For example, Social Security benefits to survivors are determined by law.

TAX EXPOSURES: those taxes, federal, state and local, that are or might be levied on property.

2 Evaluating the Estate -- The Estate Assets

The ESTATE ASSETS are, generally speaking, anything a person owns that has value. Legally speaking, ASSETS CONSIST OF PROPERTY THAT IS AVAILABLE TO PAY DEBTS.

The first category of assets is PROPERTY, which may be divided into REAL PROPERTY and PERSONAL PROPERTY.

2.1 Real Property

REAL PROPERTY is more commonly called REAL ESTATE. If we wish to be technical, then we would say that REAL PROPERTY refers to LAND, as well as to the BUILDINGS AND IMPROVEMENTS on it, and REAL ESTATE refers to the OWNER'S INTEREST in the property.

Real property includes PRIMARY RESIDENCES; VACATION/SECOND HOMES; RENTAL PROPERTY; UNIMPROVED PROPERTY; PROPERTY IN AGRICULTURAL USE.

Note: In determining an estate's tax exposures, it is particularly important to be aware of the different types of taxation levied on real estate according to USE, as well as value.

INTERESTS in real estate may be of several kinds. By INTEREST is meant a SHARE IN. As we will see, the share may be PARTIAL or TOTAL.

FEE SIMPLE ESTATE: real property is held by the owner, with no claims of any kind against it that would keep the owner from mortgaging, selling, or otherwise disposing of the property either in the owner's lifetime or at death. This is a TOTAL share.

LIFE ESTATE: real property is held only for the duration of a named person's life; this person may be the one holding the property, or it may be someone else. This share is TOTAL, but for a LIMITED amount of time.

Example: Harold Smith owns a large piece of timberland that produces income annually. Harold wants the land to go to his son eventually, but he also wants his mother provided for. He gives his mother a LIFE ESTATE in the timberland: it will go to his son at her death. Or, let us suppose that Harold's mother owns the land. Harold gets in financial difficulties and needs the annual income. His mother wants to leave the land to Harold's son, but she also wants to help Harold. She gives Harold a life estate in the timberland, to terminate at her death. Then the land will go to her grandson.

TENANCY FOR YEARS: a person has an interest in the land which will terminate at the end of a set number of years. The share can be PARTIAL or TOTAL, but is for a definite limited time.

TENANCIES IN COMMON: two or more persons each have an undivided interest in real property which, when a person dies, is passed directly to that person's heirs, not to the surviving tenants. Oil leases are an example of this. The share is PARTIAL, but the owner has lifetime control over it.

JOINT TENANCIES: two or more persons have an interest in real property, whose interest goes to the surviving co-owners when a person dies. The interest is PARTIAL, and the owners MAY NOT DETERMINE to whom the interest will go.

COMMUNITY PROPERTY: Under a community property regime, found in states such as California and Louisiana, property acquired by a husband and wife during their marriage is owned by both, with an undivided interest of one-half held by each.

In making a list of the estate's assets, all real property should be listed, and the kind of interest as well as the proportion of the interest should be noted.

Example: Agent Williams is making a list of Client A's assets. Client A is purchasing a primary residence with his/her spouse. Client A is purchasing a vacation home with his/her children. Client A is also purchasing a hunting camp with three other hunters. Each of these pieces of property has a different tax status, based on both USE and VALUE, and each piece also differs in the amount and type of control Client A has over its disposition. Such differences will affect the value to the estate of these various properties, particularly in terms of providing resources to cover beneficiary/survivor needs.

2.2 Personal Property

PERSONAL PROPERTY is the second category of property, and it may be divided into TANGIBLE PROPERTY and INTANGIBLE PROPERTY.

TANGIBLE PROPERTY has SUBSTANCE and FORM: it can be seen, touched, held, used. It has VALUE and/or UTILITY in itself. Tangible property includes cash; jewelry; household furnishings; vehicles/boats/planes; clothing and other personal possessions.

INTANGIBLE PROPERTY does not in itself have utility and/or value: it simply REPRESENTS or GIVES EVIDENCE of value. For example, a share of stock--that is, the paper document--does not in itself have either utility or value, but merely represents the interest the owner has in the body issuing the stock. Intangible property includes ROYALTIES from a book, a mineral lease, etc.; STOCKS; BONDS; PENSION RIGHTS; ANNUITY RIGHTS; RIGHTS IN A LAWSUIT--any interest owned by an individual in an entity or activity which does or might have utility and/or value.

As with real property, a person may have different types of interest in personal property. A person may have a PRESENT INTEREST in personal property, or a FUTURE INTEREST.

Example: Mary owns a matching diamond necklace, bracelet and earring set which she has given to her daughter Jean, with the stipulation that Jean does not take possession of the jewelry until Mary dies. Mary has a PRESENT interest in the jewelry. Jean has a FUTURE interest. If Jean is working with an estate planner, that jewelry could be listed as a possible resource, depending, of course, on whether Jean outlives her mother.

Other types of interest include a VESTED INTEREST, which gives a person a present right to the property's value either in the present or at a time in the future.

Example: Marian has a VESTED pension plan with ABC Company. This means she has a PRESENT RIGHT to its value, either in the present or at a future time. Under such a plan, Marian will receive a portion of the plan's benefits even if she leaves ABC Company to work elsewhere. This is in contrast to an UNVESTED pension plan, under which Marian would have no right to any benefits were she to leave ABC Company before her designated/selected retirement date.

Yet another type of interest in personal property is a CONTINGENT interest.

Example: Marian's husband Bill has a CONTINGENT interest in Marian's VESTED pension plan, in that he is the named beneficiary who will receive the plan's assets if Marian should predecease Bill before receiving the entire amount guaranteed her.

Note: While technically survivor benefits are not considered part of an estate's assets, since they cannot be used to pay estate debts, they should be listed as sources of funds to provide for the survivor's welfare, thus freeing other funds for debt payment or investment.

2.3 Business Property and/or Interests

Another category of assets is BUSINESS PROPERTY AND/OR INTERESTS. This category includes BUSINESS OWNERSHIP, VESTED INTEREST IN A PENSION, GROUP LIFE INSURANCE, GROUP HEALTH INSURANCE, AND NON-QUALIFIED PLAN BENEFITS.

BUSINESS OWNERSHIP can be of several types: SOLE PROPRIETORSHIP, PARTNERSHIP or STOCK IN A CORPORATION.

At death, no asset deteriorates as quickly as a business. Unlike tangible property such as automobiles, jewelry, etc..., which has a determinable value, the value of a business relies very much on the person at the helm. If the business is a sole proprietorship (owned by only one person) and the owner dies, the continuation of the business may be in jeopardy. If the decedent's family depended on this business for its sole means of support, their livelihood may be at stake. If the decedent's business interest is a partnership (owned equally by two people) or stock in a corporation, a spouse who knows nothing about the business may inherit a share of the partnership or corporation and could jeopardize the business through ill-management and poor decisions. If your client has a business interest, it may be wise to look into a buy-sell agreement which allows a key person in the business to buy out the decedent's interest to the mutual advantage of the decedent's survivors and of the business.

For example, Henry owns a profitable clothing store which he runs with his manager, Sam, and several salespeople. Henry started the business as sole proprietor and is the driving force behind its success.

However, Sam has been with him from the beginning and knows the business well enough to be able to run it capably after Henry's death. The business is the major source of income for Henry's wife and two children. After his death, he has arranged a buy-sell agreement with Sam that allows Sam to buy the business from his estate for an agreed upon price (which is renegotiated annually to keep up with growth) upon his death. Henry counts on the capital his wife will receive as being investment capital which she can invest and use to support herself and their children for years to come. Sam, in order to be able to buy out Henry, takes out a life insurance policy on Henry's life for the amount they agreed the business was worth. At Henry's death, Sam collects from his insurance policy, pays Henry's widow and owns the store outright. Thus Sam's livelihood is provided for as is the livelihood of Henry's widow and family. Had Henry not signed a buy-sell agreement with Sam, his widow would have owned the business and, not knowing how to run it, may have managed it poorly and lost it. It is important to remember that the value of a business asset is often dependent upon the owner of that asset.

VESTED INTEREST IN A PENSION means that monies are due even if the person had not yet retired when he/she died. If Rebecca worked for several different employers in her lifetime and had vested interest in pension plans from each employer (that is, she has a right to the value of the pension even though she has left the company), the value of each of these pension plans can be considered an asset of the estate.

GROUP LIFE AND GROUP HEALTH INSURANCE often have cash value as do NON-QUALIFIED PENSION PLANS. The estate owner may work for a large company which provides group life or health insurance to its employees. These insurance policies may have a cash value and should be considered as estate assets.

2.4 Rights and Royalties

Another category of assets to consider is RIGHTS AND ROYALTIES. Rights give the holder the privilege of subscribing to a particular stock or bond. For instance, stock owned by a father may have been passed down through the family. The estate owner may want to will the right of this stock to a child. This right would be considered an asset. Royalties can include shares paid to authors, composers, inventors, etc... or to holders of oil or mining leases. Similarly, royalties from a creative work of the estate owner can be considered assets to be willed to beneficiaries. If the estate owner wrote a best-selling book which will continue to sell after his/her death and may ultimately be made into a movie, the royalties from all of this production will be a valuable asset to the estate.

2.5 Government Benefits

And lastly, when calculating assets, one must consider any GOVERNMENT BENEFITS, social security and other statutory benefits (such as military benefits), to which the decedent may be entitled. While eligibility and amount of these benefits are determined by law, a claim for them must be filed by survivors. For example, under social security, if the spouse of the decedent is caring for at least one child who is under age 16, this spouse would be entitled to monthly social security benefits. Also, a child's benefit is payable monthly for each child who is under age 18. The government has guidelines governing the distribution of social security benefits and it would be wise to familiarize yourself with them.

Veterans' benefits can also contribute to the overall value of the estate's assets. There is a pension benefit available to widows or widowers of nearly all deceased veterans, with benefits restricted according to income.

Both social security benefits and veterans' benefits should be figured in when determining the total value of estate assets.

As an example of how to determine the assets of a client's estate which are derived from business property and interests, let us suppose that we are calculating the estate of George and Maude Jones. George fought in the Korean war and was honorably discharged from the military. When he returned

to the United States, he worked for a large corporation where he had vested interest in their pension plan. After ten years with this company, he decided to start his own business and opened a restaurant in partnership with Mark Owens. He and Mark made a buy-sell agreement that Mark would buy his share in the business should George die first for an agreed upon amount. When calculating George's potential estate assets, one should consider any veterans' benefits Maude will receive as his widow, the value of his vested interest in the company pension plan (even though he no longer works there) and the value of the buy-sell agreement which Mark will pay to his estate.

2.6 Estate Liabilities

Now let us look at ESTATE LIABILITIES in order to arrive at a clear picture of the overall value of the estate, or the ESTATE'S NET WORTH.

ESTATE LIABILITIES can be categorized into two groups: THOSE LIABILITIES INCURRED DURING THE LIFETIME OF THE DECEDENT AND THOSE LIABILITIES, THE FINAL EXPENSES, WHICH WILL ARISE UPON DEATH.

LIABILITIES DURING LIFETIME

The first grouping, LIABILITIES INCURRED DURING THE DECEDENT'S LIFETIME, includes any outstanding mortgages or loans, both secured and unsecured. This can mean home mortgages, automobile loans, and education loans (whether they are secured with collateral or not). Also in this category fall any unpaid bills (household, credit card, etc...) The routine household bills are good starting points for estimating this liability. And, finally, also in this category fall any pending suits or other possible unresolved legal liabilities. (For instance, if the decedent had been in an automobile accident during his lifetime and was involved in an ongoing suit when he died).

It is important to have your client look carefully at daily expenditures and at the real cost of living in order to fully understand the estate's potential liabilities. What are the monthly household expenditures for the family? How much monthly income will they need after the client is gone? Look at grocery bills, telephone and utility bills, dry-cleaning bills, rent or mortgage payments, car payments, gasoline and maintenance, education expenses for the children, and medical expenses not covered by insurance. The list is endless. The client should compile a detailed budget of every possible expenditure in order to understand the complete financial needs of the survivors. There may be some expenditure that will no longer be necessary after the client is gone. For instance, if he was an avid golfer with country club dues of several hundred dollars a month, when he dies these dues may not be necessary and this could present a saving to the estate. It is important to look at all expenditures with an eye toward conservation in the present and to begin to identify those areas where reductions would be made at the death of a family member. What is discretionary spending and what is necessary spending?

Note that the date of death marks the point at which the decedent's estate becomes operative as the legal entity responsible for certain liabilities. Clearly identifying both the legitimate assets and the legitimate liabilities of an estate is of primary importance if an estate plan is to effectively serve a client and his/her family and interests. Particularly in a time when pre-nuptial agreements are becoming a norm, ALL documents defining asset ownership and/or control, and affecting their disposition, must be assembled, reviewed, and integrated into the estate plan, either as is, or with appropriate amendments.

LIABILITIES ARISING UPON DEATH/FINAL EXPENSES

The second grouping, LIABILITIES WHICH WILL ARISE UPON DEATH OR FINAL EXPENSES, can be a major cause of estate shrinkage. Final expenses can include the following: MEDICAL EXPENSES, FUNERAL EXPENSES, ESTATE ADMINISTRATIVE COSTS, and TAXES OWED.

MEDICAL EXPENSES refer to unforeseen expenses of final illness and dying. If the decedent was in need of hospital or custodial care during his or her final days, some of that care may not have been covered fully by health insurance. Expenses can include inpatient charges, doctors' fees, medication, room and board, 24 hour care, etc. The estate will be liable for these expenses shortly following death.

FUNERAL EXPENSES refer to the cost of a burial plot (which can be planned for and purchased in

advance), the cost of a tombstone, any expenses related to the funeral event itself (i.e., fees paid to funeral homes, the cost of transportation of the body, florists' fees) and prepaid expenses for future care of the burial site. Because funeral expenses are incurred at a time of great emotional stress, families often find themselves committing to pay what they can't afford. During the planning of the settlement of the estate, we should encourage the client to prepay as many of these expenses as possible.

ESTATE ADMINISTRATIVE COSTS

The process of settling a deceased's estate can be time-consuming and costly. Some of the many hidden costs include:

- ◆ executor's fees
- ◆ attorney's fees
- ◆ court costs
- ◆ appraiser's fees
- ◆ accountant fees
- ◆ property insurance
- ◆ ancillary administration costs
- ◆ liquidation costs

It is wise for estate planners to become thoroughly versed with the probate process within their jurisdiction. While no one but an attorney can give legal advice, this knowledge will help you to better plan with your client.

The first step in the settling of an estate is the naming of an administrator or an executor (If a female serves in either capacity she is called an executrix or administratrix). If a will exists, an executor is designated by the will. If the decedent died intestate (left no will) an administrator is appointed by the court to oversee the settling of the estate. Settlement of the estate can be overseen by persons or entities (for example, the trust department of a bank) and more than one person or entity can be appointed or designated as co-administrators or coexecutors.

A will designating the decedent's desires for administration is the best assurance that those desires will be carried out. Often, an estate owner will designate a family member and a bank officer or trust company as coexecutors so that both the personal and financial concerns of the estate will be considered after death. If there is no will, estate administration is left to one appointed by a court unfamiliar with the particularities of the estate owner's desires.

Because the client's will is the legal instrument by which his or her estate will be dispersed, it is essential that the will supports the estate plan and for this reason, it is important that an estate planner gain the client's confidence to the point where the estate plan will be the foundation for the legal will. According to IRS studies, the cost of opening, administering, and closing the estate averages about 4%- 5% of the typical estate. Expenses can include:

- ◆ The *executor's fee*, which may be waived, but is his/her right in compensation for work done. Also, in some cases, a performance bond will be necessary (look up performance bond).
- ◆ The *attorney's fee* which is the cost of an attorney to advise the executor and prepare documents.
- ◆ Court costs for filing any necessary forms and papers. These costs can rise in direct relation to the complexity of the estate and whether or not the settlement is contested in a prolonged battle.
- ◆ Fees to an appraiser who must be hired to value all general assets of the estate (personal and real property, antiques, jewelry, art, etc.). Note that property and casualty insurance policies may have scheduled lists of certain assets--jewelry, artwork, antiques, and other valuables. These schedules should be reviewed when the estate plan is drawn. Depending upon the recency and accuracy of such insurance schedules, they can provide a guide in estimating the possible value of certain types of personal property in the estate.
- ◆ Accountant's fees, if a business interest is part of the estate, to determine the value of that asset.
- ◆ While the estate is open, estate property must be insured and maintained, incurring more expense in the form of *property insurance*.
- ◆ If the decedent owned property in another state, often *ancillary administration* is needed to handle

- the settlement of that property in the other state, at more cost to the estate.
- ◆ Finally, if any estate property is sold, there may be *liquidation costs* in the form of brokerage fees, auctioneer's fees or commissions due on the sale.
 - ◆ All of the above mentioned fees and expenses must be paid, in full, and usually from the assets of the estate.

TAXES OWED

Expenses falling in the category of TAXES OWED include FEDERAL ESTATE TAXES, FEDERAL AND STATE INCOME TAXES, STATE DEATH TAXES, and UNPAID PROPERTY TAXES.

TAXES on death are generally progressive in nature. The federal estate tax, for example, ranges from the lowest rate of 18% up to a rate of 55% for estates larger than \$3 million. There's an additional 5% penalty on taxable estates between \$10 million and \$20 million. Following are some recent estate tax cutoffs:

CREDITS which may be applied against the net amount of federal estate tax due include the following:

- ◆ *Unified estate and gift tax credit*
- ◆ *State death tax credit*
- ◆ *Foreign death tax credit*
- ◆ *Credit for tax on prior transfers*

The **FEDERAL ESTATE TAX** (gross estate) must be paid within nine months of death. This problem which can be eased in several ways, chief among which , at least in the case of married people, is the use of the unlimited marital deduction to reduce the federal estate tax liability. This deduction permits any amount of property to be transferred to a surviving spouse at death, free of the federal estate tax.

<u>Taxable Estate</u>	<u>Tax Before Credits</u>	<u>Marginal Estate Tax</u>
\$150,000	\$38,800	32%
\$500,000	\$155,800	37%
\$1,000,000	\$345,800	41%
\$2,500,000	\$1,025,800	53%
\$3,000,000	\$1,290,800	55%
\$5,000,000	\$2,390,800	55%

After death, the decedent's estate is liable to the government for any INCOME TAXES OWED TO THE STATE OR FEDERAL GOVERNMENT for income earned during the year until death. In the same manner, the estate is liable for payment of any PROPERTY TAXES uncollected for the year until death.

STATE INHERITANCE AND ESTATE TAXES vary (none in California) but it is safe to assume that tax will be due and an investigation into the particular laws of the state where the estate owner resides would be wise. As with any of these taxes, lack of foresight and planning for them can cause major estate depletion during the settlement.

2.7 Determining Net Worth

It is an invaluable exercise for you to have your client fill in the following charts documenting all estate assets and estate liabilities. Often, when an estate owner dies, information about hidden assets dies with him/her. People have been known to bury money in the backyard, hide it away in foreign bank accounts or safety deposit boxes no one knows about. There may also be insurance policies with cash value. You should impress upon your client the importance of giving a thorough and honest picture of the estate assets and liabilities so that you can accurately determine the estate's net worth. (Attach chart combined from three resources).

Your client has spent a lifetime accumulating what is now considered his/her estate. One of his/her major considerations as he/she plans for the future of this estate is that he/she be able to dictate what

happens to that estate after he/she is gone. No matter how simple an estate is, normally, if it is of sufficient substance to require an estate plan, there will be assets to conserve, assets to disperse, and assets to manage so that they may continue to produce income/benefits. There may be businesses that must be conserved, certain bequests to distribute, and other assets to be managed, such as stock portfolios. Sometimes, because the estate has not been well planned, there is not enough ready cash from the estate to pay for the final expenses (often unforeseen) and the estate is forced to sell assets at a loss just to get immediate cash. In order to avoid this, we want to look at the NET WORTH of the estate by considering the following categories:

1. Total liquid assets
2. Total non-liquid assets
 - a. Short term cost of turning non-liquid assets into cash, which include:
 - 1) Loss of any monthly revenue produced by the asset, such as loss of rent from rental property, or interest income.
 - 2) Immediate cost of selling the property, whether through a commercial entity, in which case there will be fees and commissions, or personally, in which case there could be the cost of advertising, the cost of legal documents transferring the property, the cost of legal and accounting advice.
 - b. Long term cost of turning non-liquid assets into cash, which include:
 - 1) Assets sold soon after a death in order to raise cash to pay estate debts rarely are sold at even the current market price: the seller's need for cash creates a buyer's advantage. And so the immediate sale price is often less than it should be.
 - 2) Depending upon the nature of the asset, its future value may be much higher than the price put on it when it is sold shortly after the owner's death. Most long-term investments are chosen with an eye to future value: a forced sale disrupts the investment plan, and results in a loss of anticipated future gains.
3. Known liabilities
4. Presumed liabilities

2.8 Total Liquid Assets

LIQUID ASSETS are cash, or assets which can be readily converted into cash without any serious loss. These assets include ANY CASH THAT IS IN BANK ACCOUNTS, BOTH SAVINGS AND CHECKING, IRA AND KEOGH PLANS, PROCEEDS FROM LIFE INSURANCE POLICIES, EMPLOYER SAVINGS PLANS, EMPLOYER LUMP-SUM PENSION BENEFITS, and GOVERNMENT BONDS. When documenting potential liquid assets, the estate owner should be sure to include any CASH ACCOUNTS, SAVINGS OR CHECKING, at home or abroad.

IRA AND KEOGH ACCOUNTS and employer-sponsored programs such as 401(K) PLANS waive the early withdrawal penalties in cases of death so money an estate owner has saved through these plans is payable without penalties to survivors.

If the estate owner is covered by a pension plan at work, he may be eligible for a LUMP-SUM SURVIVOR'S BENEFIT payable upon his death. However, the pension benefit may be paid monthly instead. This should be determined by consulting the plan or the employer.

Any LIFE INSURANCE POLICIES can be considered as liquid assets as they will be payable to the estate upon death. EMPLOYER PROVIDED GROUP INSURANCE should be included. Credit-life or mortgage policies should not be included as they will simply pay off credit debts or mortgages and will have no intrinsic cash value.

GOVERNMENT BONDS, also known as US Savings bonds, can be cashed in at any time with no loss of principal so they can be considered as liquid assets. However, if the bonds are cashed in before they are due, there may be a reduced yield. Example: For a ten-year savings bond which sells for half its face value of \$1000.00 the estate owner paid \$500.00. If the owner dies five years after buying the bond, he will get his \$500.00 plus interest due but will not get the full yield of \$1000.00 due to premature withdrawal.

Once all liquid assets have been computed, the estate planner can arrive at an estimate of cash that will be available to the estate immediately upon the demise of the owner.

2.9 Total Non-Liquid Assets

NON-LIQUID ASSETS are assets that are not readily convertible into cash for at least nine months without a serious loss. This includes REAL ESTATE, BUSINESS INTERESTS, MUTUAL FUNDS, STOCKS, AND PERSONAL PROPERTY ITEMS SUCH AS ART COLLECTIONS, COIN COLLECTIONS OR ANTIQUE FURNITURE.

The liquidity of REAL ESTATE will be determined by the real estate market at the time of the estate owner's demise. We consider real estate a non-liquid asset because though one could probably sell any real estate immediately for a price, that price may be much lower than the value of the property and it would be better for the overall health of the estate to be able to wait to sell when it is most profitable to the estate.

BUSINESS INTERESTS could be sold at a loss to the estate if the sale is absolutely necessary at that time. However, a goal of the estate plan is not to shrink the estate, so we would consider holding business interests from liquidity until the estate can profit most from a sale (unless a buy-sell agreement was in effect as aforementioned).

The value of STOCKS AND MUTUAL FUNDS depends on the value of the market, so these are not considered to be liquid assets. Though one could sell the stocks and mutual funds if necessary, it is better for the estate if the sale can be made when prices are at their highest.

ART COLLECTIONS, COIN COLLECTIONS AND ANTIQUES are subject to the same time sensitivity as are the above mentioned assets. Because their value is based on demand and a fluctuating market, they are not considered liquid assets. In order to get the best price for a sale of these assets, one would want to be able to watch the market and sell when the demand and value are high.

2.10 Known and Presumed Liabilities

It is essential to consider both the long-term and short-term costs of converting non-liquid assets into cash too quickly to recuperate their full value. Proper Estate Planning will take into account all KNOWN LIABILITIES such as MORTGAGES AND LOANS and all PRESUMED LIABILITIES such as ESTIMATED MONTHLY HOUSEHOLD BILLS (INCLUDING OUTSTANDING BALANCES ON CREDIT CARDS), ANY PENDING SUITS OR OTHER POSSIBLE LEGAL LIABILITIES and FINAL EXPENSES OF ILLNESS, DEATH, FUNERAL AND PROBATE PROCESS.

As the estate planner works with the estate owner, he/she weighs all possible estate assets against all possible and foreseeable estate liabilities and designs a strategy whereby all liabilities can be met. During this process, new asset resources may need to be implemented (such as the purchase of life insurance policies to cover a buy/sell agreement for a business, for example) or the estate owner may discover that he/she must adapt his/her desires for estate dispersal based on actual assets rather than wishful thinking.

After determining net worth, clients are ready to address how their estates should be dispersed after death.

3 Establishing Priorities

3.1 The Welfare of Beneficiaries

Most estate owners will have some dependents or beneficiaries for whom they would like to provide after their death. These can include minor children (for whom your client will want to provide for financially as well as selecting a guardian should both parents die together); a spouse who may not

be able to either work or handle the financial interests of the family without adequate guidance; aging parents or other relatives who depend on your client (like an old aunt who has no living relatives except your client and whose financial well-being relies on your client's guidance) and other special cases like an exceptionally talented child for whom your client would like to provide the financial means to develop the talent or a child with a physical or emotional disability who may never become completely self-sufficient and may always need financial support and/or guidance.

Remember, though, that estate planning is also extremely important if your client is single. Your client is planning for his/her future--not only after death but also looking at possible disability and/or long-term illness. So, the estate plan is just as important if the client has no dependents.

3.2 Surviving Spouse

Assuming that your client does have dependents and/or beneficiaries, let us look first at the welfare of the SURVIVING SPOUSE. Based on the financial data you have already accumulated, you should have a clear idea of whether the surviving spouse can be counted on to contribute income after the death of the estate planner.

Even if the surviving spouse continues to work and to contribute income to meet the family's needs, you must take into consideration that the death of the spouse may alter this income as there will now be no one to share child care (if there are minor children) and the emotional trauma of the death of the spouse may affect work habits for a period of time after the death. It is important to plan for IMMEDIATE INCOME and LONG-TERM INCOME.

IMMEDIATE INCOME will be needed to cover all of the expenses which will hit the surviving spouse at the time of death. These expenses include final expenses (outlined in Unit One) which most authorities agree could be as much as \$5,000 to \$10,000; any expenses necessary to gather the family together (such as airline tickets for children away from home); and a readjustment income which is established to provide the widow/er with the same income which was available before the spouse died. It is in calculating the readjustment income that the estate planner must take into account a realistic assessment of how much the surviving spouse may contribute.

For example: Harry is the major breadwinner in his family but his wife Sally has a part-time job as an accountant and contributes 25% of the family's monthly income. Harry and Sally have four children under the age of fifteen. When Harry dies unexpectedly, Sally goes into a mild depression and can't work for a while. Though Harry can't be expected to know that Sally will stop working after his death, if he properly plans his estate, he will plan for an immediate income which will give enough cushion for a period of grieving.

LONG TERM INCOME can fall into two categories: income for the spouse while there are dependent children and life income.

If there are minor/dependent children in the household at the time of the estate owner's death, he/she may want to provide the surviving spouse with a fixed income until the children reach a specified age, usually when the youngest child is 18. A college fund can then provide for education expenses. Alternatively, the estate owner can provide for the spouse and dependent children until the youngest child reaches 21 or 22 and eliminate the college fund, if so desired.

Life income for the surviving spouse begins when the dependency income ends and continues for life. It is important for the estate owner to determine what kind of income he/she wants to establish for his/her surviving spouse. Depending on the size of the estate and on the accustomed lifestyle of the spouse, there are various ways to insure that the standard of living of the spouse and children of the deceased will not deteriorate after death.

Using a combination of social security benefits (which can be claimed after age 62, or by choice beginning at age 60), retirement benefits (if the husband lived to age 65), cash from life insurance policies, income from rental property or business, and savings, the estate owner can insure that his/her spouse will have the income necessary for a sound financial future.

Note that while social security benefits are payable to minor children until the age of 18 (or 22 if the child is a full-time student), they are not payable to the spouse until the age of 62. Therefore, there will be a period of time when the surviving spouse will not be able to rely on any social security payments as part of life income support.

3.3 Minor Children

The welfare of the surviving spouse is closely linked to the welfare of MINOR CHILDREN upon the death of the estate owner. When considering the welfare of minor children, the estate planner should consider BASIC SUPPORT needs as well as financial needs for EDUCATION. Also, the estate owner may have certain LEGACIES or SHARES he/she may want to will to a minor child.

Basic support for minor children includes such basic expenses as food, clothing, shelter, health insurance and medical bills, and such special expenses as private schooling or an automobile if the child is of driving age. Some of these expenses will overlap with the expenses of the surviving spouse and will be covered as general family expenses.

However, there may be a special case in which one child incurs special expenses such as dance lessons for a gifted young dancer, and, potentially, travel for auditions to schools and companies where she can develop her talent. These expenses should be considered as separate from the general family expenses but should be provided for.

Some special expenses may seem like education expenses. It is important when devising an estate plan to determine the value that the estate owner places on education in his/her plan. If education is a priority, you must determine what level of funding the client wants to plan for. Many college tuition today run as much as \$8,000 per semester. If a client has four children and wants to send all four to Ivy-League colleges for four years each, he/she should plan for a \$32,000 education fund for tuition alone. This doesn't even begin to include books, living expenses, and travel to out-of-state colleges.

Finally, when planning for minors, the estate owner should also consider any particular legacies or shares which he/she will want to pass on to minor children. These may include, for a father, the heirloom gold pocket watch that went to the eldest son of the eldest son since the 18th century or, for a mother, the wedding ring which was her grandmother's. These legacies can be written into the will but they should be established.

Also, if the estate owner wishes to pass on shares he/she owns in a business, this can be designated in the plan and a trustee or guardian appointed to help the minor oversee these shares until he/she reaches maturity.

Note that the gift of property to a minor may work against you unless the property is something that the minor can get immediate benefit from (ie, jewelry, an automobile). Real estate or stocks are better transferred in trust or placed in a custodianship under the Gifts to Minors Acts in force in the various states. This allows for the property to be managed to the minor's benefit until he/she can manage it him/herself (see Unit Seven: GIFTS).

It is essential, when considering the financial well-being of minor children, that an estate owner consider the choice of a guardian for his/her children in the eventuality of the death of both parents. Encourage him/her to choose someone whose lifestyle and child-rearing patterns are compatible with those established and who has agreed to undertake the responsibility.

It is also important to designate an alternative guardian in case the original choice has to refuse the responsibility because of changed circumstances. If the estate owner feels that for some reason the children will not be able to manage their inheritance responsibly after age 18 or 21, when the guardianship is terminated, you might encourage him/her to establish a trust (see Unit Four: USING TRUSTS).

3.4 Adult Children

In the case of ADULT CHILDREN (over the age of 22 and finished college) one can usually assume that they have the maturity to handle finances and that they are at the beginning of their own earning years. While it is not necessary to provide them with the basic support and educational expenses which one considered for minor children, it is necessary to determine how much an estate owner wants to contribute to the financial well-being and long-term security of these children after his/her death.

The estate owner has the option of specifying IMMEDIATE BEQUESTS AND/OR SHARES or CONTINGENT BEQUESTS AND/OR SHARES.

It is advisable, when making a will, to specify bequests in percentages rather than in fixed dollar amounts. For instance, the estate owner may wish to leave 75 percent of the total estate to his/her spouse and divide the remaining 25 percent among his/her children.

It is also advisable to designate one or more contingent beneficiaries in the event that a named beneficiary dies before the estate owner. Although the law prohibits disinheritting a spouse, children can be disinherited. It is advised to specify those people to whom you do NOT want to leave anything.

Assuming that the estate owner wishes to leave bequests and/or shares to his/her children, there are several ways in which he/she can do this. The bequests/shares can be made immediately--which means that at the time of death, when the will is read, property, cash or shares in a business are turned over to the named beneficiary and he/she must pay the necessary taxes established by the government. Or, the bequests/shares can be made contingently which means that the transference of property, cash or shares in a business doesn't occur until the contingency is met--ie..contingent upon the death of the surviving spouse.

The estate owner could choose to leave 75% of his estate to his wife, which she will claim upon his death. He could then decide that, contingent upon her death or remarriage, this 75% will be equally divided between the four children of his marriage to her. He could then designate 25% of his estate go immediately to his children to be divided equally. Thus the children would receive, upon his death, 25% of their father's estate and, upon their mother's death or remarriage, equal shares in the remaining 75% of their father's estate. In this way, the estate owner has prevented any of his estate earnings going to beneficiaries other than his own children.

3.5 Beneficiaries With Special needs

As well as considering the needs of the surviving spouse, the minor children and the adult children, the estate owner must also consider any BENEFICIARIES WITH SPECIAL NEEDS such as family members who have physical, mental or emotional disabilities.

Suppose that the estate owner has a child with a mental disability whose mental capacity is that of a six year old and the child will never mature past that capacity. Parents have the right to act on behalf of a minor, but once the child reaches the age of maturity, the parents must have him/her declared legally incompetent and themselves appointed his/her guardian to handle his/her affairs.

However, what if both parents die? Who will take care of this adult/child? It is urgent that the estate owner specify who would be the best guardian for the child and establish financial security for the child throughout his/her lifetime. This scenario is entirely different from that involving other adult children for they will be able to fend for themselves. A legally incompetent adult will need care and guidance.

When considering bequests to a child with a physical, mental, or emotional disability, consider what benefits this child may be entitled to already from federal or state programs. Some programs are based on need, such as Supplemental Security Income (SSI) and Medicaid while others, such as Social Security and Medicare, do not have income or asset eligibility restrictions.

If the estate owner's child can receive benefits from programs based on need, it may be wiser to disinherit the child from receiving any financial benefits because these may jeopardize his/her program benefits. In this way, estate assets wouldn't be wasted where they are not needed. The child could be provided for with other means, and the estate assets can go towards provision for other children

and the surviving spouse.

Other possibilities for providing for a child with a disability include a morally obligated gift, which allows the estate owner to leave a bequest to someone he/she trusts and ask that beneficiary to use the money for the child.

A trust may also be used. When setting up a trust for a child with a disability, it is imperative that the trust be drafted so that the child will benefit from the trust assets without those assets disqualifying him/her from receiving government aid and assistance. It is essential that an estate owner work with an attorney who understands the very unique needs of estate planning when a person with a disability is involved.

In summary, when considering the welfare of beneficiaries of the estate, it is important to ask:

1. Whom do I want to benefit?
2. What needs do I want to meet for that person (or persons)?
3. What way can I best meet those needs?

It is by answering these questions honestly and thoroughly that the estate owner and the estate planner will be able to establish priorities concerning the future welfare of beneficiaries to the estate.

3.6 Continuation and/or Disposition of the Business

If an estate owner was a business owner, he/she must also consider the CONTINUATION AND/OR DISPOSITION OF THE BUSINESS. Whether the business is a proprietorship (owned by one person), a partnership (owned by two or more partners), or a corporation (owned by one or several stockholders) there are several options which will present themselves at the death, disability or retirement of any one of the owners:

- ◆ FORCED LIQUIDATION
- ◆ PLANNED LIQUIDATION
- ◆ PLANNED RETENTION
- ◆ PLANNED SALE

Clearly, FORCED LIQUIDATION of a business is the least desirable option as a forced sale would never yield the best value for the business and the estate would suffer a loss.

However, unless adequate planning has been done, the executor of an estate may need the immediate cash for estate settlement costs and taxes and may have to sell the business as the only substantial asset which can be converted into cash.

If there is no one who is capable or interested in taking over the business after the death of the owner, he/she can plan to provide the funds equivalent to the approximate value of the business to the heirs, while allowing the business to be sold. This is called PLANNED LIQUIDATION.

By planning liquidation, the estate owner can ensure that the estate will have necessary cash on hand at settlement and the business can be sold with less urgency.

If the business has been in the family for a very long time or there is someone among the heirs who is particularly suited to take over and continue the profitable operation of the business, the estate owner can plan for the retention of the business. If the estate owner opts for PLANNED RETENTION, provisions such as who will take on the responsibility and the financial details of the transaction should be decided during the owner's lifetime and clearly outlined in the will.

A PLANNED SALE of a business is perhaps the most complicated option but often the most useful, especially if there is no one among the heirs who could profitably take over the owner's interest in the business. At the death of the estate owner, his/her interest in the business becomes part of the estate.

Whether this interest is sole interest (as in a proprietorship), shared interest (as in a partnership) or as a majority or minority stockholder (as in a corporation) the disposition of this interest must be dealt with.

We have already seen that if no plans are made ahead of time, this interest could be forcibly liquidated. We've examined options of the interest being liquidated through planning and of interest being retained through transfer to an heir.

If, however, the estate owner wishes his/her business to continue but not through transfer to an heir, he/she can plan to sell the business to someone with whom an agreement has been made long before death and can implement a buy/sell agreement detailing and contracting this arrangement.

A price can be agreed upon (which will be reexamined every several years and reevaluated) and a life insurance policy can be bought on the estate owner so that upon his/her death, the buyer will have the funds with which to carry out the agreement.

Clearly, this is an optimal solution to the disposition of the business as everyone wins. The estate owner knows that a business he/she built up through a lifetime will continue. The buyer, usually an employee in that business, is assured continuation of livelihood and the estate benefits from the immediate influx of cash.

It is clear, then, that in establishing priorities for continuation or disposition of business interest, it is important to determine:

- ◆ Should the business be continued and, if so, will there be an heir who can profitably run the business or should it be sold to an employee or to an outside party for the best price.
- ◆ If there is no one to run or to purchase the business, should a plan be made to liquidate the owner's interest in said business at his/her death in order to provide the estate with immediate cash to cover taxes and settlement expenses.

3.7 Administration of the Estate

As the estate planner works with the estate owner to establish priorities concerning the welfare of any beneficiaries of the estate and the continuation or disposition of business interests, he/she should also discuss with the estate owner how the estate should be administered or dispersed when the time comes. There are three legal means by which an estate can be administered:

1. By means of a will
2. By means of a trust
3. By means of a power of appointment

3.8 Administration Under A Will

As we have already asserted, it is imperative that your client draw up a WILL with a lawyer skilled in estate law. Without the presence of a will, the court will appoint an administrator to the client's estate and it is unlikely that the estate will be settled according to the client's wishes--for there is no real way of knowing what those wishes are.

The will allows the estate owner to determine who will be the executor (or executrix) of the estate and exact details of how that estate should be disposed. The executor/trix has the responsibility of collecting any property (such as accounts receivable) due the estate, paying any debts, expenses, and taxes owed by the estate, and distributing assets of the estate to any beneficiaries. Through a will, an estate owner can specify exactly what should go to whom and how liabilities should be paid and assets distributed.

3.9 Administration Under A Trust

If the estate owner feels that the beneficiaries of an inheritance won't be able to competently manage that inheritance because they are minors, elderly or financially unsophisticated, he/she may wish to set up a TRUST. Trusts can be set up during the estate owner's life (inter vivos) or through the means of the will (testamentary). In the case of a trust, the estate owner would create a will which outlined certain parts of the inheritance to be set up in a trust. The trust's primary use is to manage and distribute the property granted to the trust by one party, the grantor, for the benefit of another party, the beneficiary.

The trustee does not have to be a financial expert or business person; the estate owner can designate any individual whom he/she believes can properly manage the property involved for the benefit of the beneficiary. The legal ownership of the property in trust is held by the trustee. However, the beneficiary of the trust holds equitable title to the property since the trust exists for his/her benefit.

3.10 Administration Under Powers of Appointment

Sometimes, the estate owner wishes to leave property to a beneficiary or beneficiaries but doesn't know what the future needs of that beneficiary or beneficiaries will be. In such a case, the estate owner could employ the power of appointment, a legal device often used with gifts and trusts.

The power of appointment allows the estate owner (the grantor) to grant power to a donee whereby the donee can appoint or name the recipient of the grantor's property at some future time. This gives the estate owner the flexibility of allowing someone else, at a future time, to decide how best the property may be dispersed when the best dispersal plan is not obvious.

For instance, if Harry has three grandchildren who are under five years old when he is planning his estate, he may wish to provide for them in some future way but not know how best to do that at such an early time in their lives. Harry can grant power of appointment to the children's father. This power can govern the eventual disposition of a trust which Harry sets up in his will to benefit the three grandchildren. At the time of Harry's death, his son will take control of the trust and will have the freedom to disperse the assets to his three children according to his best judgement, providing he abides by any regulations of the trust agreement.

Power of appointment provides great flexibility in the total estate planning process. Note that there are two major types of powers of appointment:

1. General power of appointment which allows the donee to pass on an estate asset to whomever he/she pleases
2. Special power of appointment which authorizes the donee to pass on estate assets only to certain designated individuals or entities

Now that we have evaluated the estate and established priorities for the disposition of the estate, we will look more closely at these various ways of administering the estate, particularly WILLS and TRUSTS.

4 Wills

4.1 Legal Requirements Affecting Wills

The will is a legal document, governed by state laws which vary from state to state. It is essential that a qualified attorney be consulted on the legal requirements of the state you are working in. An attorney should also oversee the will making process to ensure that it conforms to applicable laws. However, as part of the estate planning team, you should have a basic understanding of the following terms and details of will execution.

By definition, a WILL is a declaration of an individual's desires as to how his/her property should be

disposed of after his/her death; it is enforceable by law.

4.2 Testamentary Capacity

In order for an individual to make a will, he/she must have TESTAMENTARY CAPACITY, that is, he/she must satisfy the legal requirements for disposition of property by will. Law requires that the individual be of a certain age (usually the age of maturity in a state though it differs from state to state and can vary from 18 to 21) and that he/she be of sound mind.

Illiteracy, the inability to write, and even low intelligence don't disqualify someone from making a legal will. However, he/she must understand thoroughly that the will is being made, that certain property is being disposed of by this will, that certain individuals are being named as beneficiaries of this property and also understands how this property will be disposed of.

Ultimately, if there is a question of soundness of mind, a court will investigate and rule. Similarly, an individual may be declared mentally incapacitated and unable to make a will at a certain time in life but may recuperate and be of sound mind later in life and then able to execute a legal will.

4.3 Types of Wills

Once the estate owner has testamentary capacity, the will must be composed. By law, the will should be written, preferably typewritten. The two forms of written wills are called ATTESTED WILL and HOLOGRAPHIC WILL.

However, there is a special death-bed exception where the will can be expressed orally. This type of will is called a NUNCUPATIVE WILL. The last type of will is called a POUR-OVER WILL. This type of will is employed to give greater flexibility in distributing assets.

THE ATTESTED WILL

An ATTESTED will must be written (handwritten or typed), signed and witnessed. It cannot be oral.

It must be signed by the testator (or by someone else who has the power to sign on behalf of the testator) and the signature must be witnessed as it is written. Several witnesses are required to sign the will in the presence of the testator (the number of witnesses necessary varies from state to state).

THE HOLOGRAPHIC WILL

A HOLOGRAPHIC WILL differs from an ATTESTED will in that it is usually handwritten and is never witnessed. This is the will that Aunt Bessie wrote in the privacy of her own home and tucked away in her file drawer with her other important papers.

If a holographic will is witnessed, it is called an attested will. Because this will has not been legally witnessed, it must be clearly and ENTIRELY in the handwriting of the estate owner and should be found with other important documents of the estate.

THE NUNCUPATIVE WILL

A NUNCUPATIVE WILL is employed when the estate owner is on his/her death-bed and doesn't have the time for an attested will or the wherewithal to write a holographic will. In this case, the law allows that the estate owner can summon witnesses to hear how he/she wishes to dispose of his/her property.

The law requires that, in order to make a nuncupative will, the estate owner must be in his/her final illness; witnesses must be present and must put the dying wishes in writing within X days (varies by state); and the will must be offered for probate within X days (varies by state).

THE POUR-OVER WILL

The POUR-OVER WILL is a will which allows any residue of the estate left after all bequests, taxes and liabilities are paid to pour over into a trust set up during the estate owner's lifetime. Because the terms of asset distribution for trusts are often more flexible than those for wills, this type of will financially benefits the estate.

4.4 The Codicil

If your client has a will filed with an attorney, as you proceed with the estate planning process he/she may decide that he/she wishes to amend the existing will. Any amendment to an existing will is called a CODICIL. Codicils cover minor changes or modifications in the will--a change in the value of a bequest, for example. Or the exclusion of a gift article which is listed but no longer exists as part of the estate such as a car which has been sold.

If there are major changes to the will, it may be necessary to make a new will and revoke the old one. Wills can be revoked in several ways. When a new will is made, it automatically replaces the previous will, revoking it. The testator can make a codicil revoking the will. The testator can destroy the current will thus revoking it.

Certain laws can revoke existing wills. For example, when a man or woman remarries in certain states, their current wills are automatically revoked.

It is recommended that all versions of an individual's will be kept on file even though they may have been revoked (in case a new will is contested). Earlier versions of a will can reveal the client's thought process as he/she progressed through various versions of a will and may back up the most current will. Or, a new will may be declared invalid and an old will used for probate instead.

4.5 Intestacy

If an individual dies **INTESTATE** this means he/she dies with no will and the state will appoint an estate administrator and dispose of the estate's assets according to law. This means that someone who has no knowledge of an estate owner's business, personality, desires, will probe into the most intimate details of his/her life and disperse his/her material possessions and assets.

Because of the way certain state laws are written, state disposition of assets could mean that a married man with two minor children could die and leave his wife only one third of his estate. In many states, when a man dies intestate, his wife and children get equal shares of the estate, even if they are minors and therefore unable to manage their inheritance. Had the estate owner left a will, he could have taken any number of preventative measures such as leaving his wife 100% of the estate until the children reached a certain age or leaving his wife 75% of the estate and establishing a trust for the children with the other 25%.

4.6 Passing of Property

State intestacy laws governing the distribution of probate property are also called succession laws or descent and distribution laws because they base the distribution of property on relationship to the deceased. When an estate owner dies intestate, some of his/her estate property escapes the probate process and is distributed according to previously agreed upon **CONTRACTUAL RIGHTS**. Other property is distributed through probate according to either **LAW**, **DEGREE OF KINSHIP**, or **ESCHEAT**.

4.7 Passing of Property by Contractual Right

Property which escapes probate by **CONTRACTUAL RIGHT** includes jointly owned property and life insurance paid to a named beneficiary. Because there are already legal stipulations in place as to the rightful ownership of this property, the property is excluded from probate.

In the case of joint ownership of assets with rights of survivorship, assets are owned jointly by two or more individuals (husband and wife; wife and daughter; etc.) and upon the death of any of these individuals, the ownership of the entire asset passes to the survivor(s) automatically and without probate.

In the case of a life insurance policy with a named beneficiary, upon the death of the policy owner, the beneficiary automatically receives the value of the policy without those monies going through probate. (Most life insurance policies settle the proceeds in a lump sum payment. However, a policy holder can usually also choose certain settlement options for dispersal.)

Other property which will escape probate is property held in a living trust at the time of the decedent's death. However, the majority of an estate owner's property will be distributed by the state through probate.

4.8 Passing of Property by Law

Each state has its own INTESTACY LAW which governs the probate of estates for individuals who die without a will. Most states forbid the disinheritance of a spouse and stipulate that the spouse is entitled to a substantial portion (one-third to one-half) of the estate.

In fact, where there is a will, the spouse can choose to select against the will if the state's intestacy laws would give the spouse a greater portion of the estate than was left by the decedent.

Some states require that household items and automobiles must be given to the surviving spouse and children. In the absence of a will, a state agency will even be forced to appoint a guardian for an individual's children if both spouses are deceased. The distribution of an individual's property and the execution of an individual's responsibilities (such as children, elderly parents) after that person's death is a complex process.

State laws are made to expedite the probate process and simplify the distribution of property and execution of responsibilities. It is the rare case when the state's execution of these duties coincides with what the decedent would have wished had he/she written a will and outlined those wishes.

4.9 Passing of Property by Degree of Kinship

When the heirs specified in a state's intestacy laws are all deceased, the property must go to the decedent's next of kin. In such a case, property is distributed by DEGREE OF KINSHIP. A determination must be made as to what family member has ancestry common to both the decedent and the heir. A comparison is then made as to whether this family member stands in closer degree of kinship to the decedent or to the heir. Those family members who are more closely related to the decedent (i.e. from the same generation) than to the heir will generally take a larger share of the intestate estate.

Example: Mary is an only child. Her parents were both only children. However, her mother has a cousin who is the child of her mother's sister. This cousin, Betsy, outlives Mary. Betsy has two children who are Mary's second cousins. Because Betsy is Mary's first cousin once removed, she is more closely related to Mary than her two children are. Therefore, though they will all share in Mary's estate, Betsy will receive the larger share.

Different states vary in their dispersal of property to next of kin. A PER CAPITA distribution of property means that property is distributed equally to all beneficiaries, regardless of their degree of kinship to the decedent. In the example above, property distributed according to a per capita distribution would be equally distributed to Betsy and her two children, with each beneficiary getting one third of the estate.

A PER STIRPES distribution means a distribution by line of descent. In the example above, suppose that Betsy's child, Mark, dies before Betsy leaving two children of his own. When Betsy dies, her surviving beneficiaries are her daughter, Claire, and Mark's two children. In a per stirpes distribution, Claire would get one-half of Betsy's estate, and Mark's children would get Mark's one-half of Betsy's estate (dividing it equally between them so giving each of them one-fourth of the total estate). Had Betsy's estate been divided according to Per Capita distribution, Claire, and Mark's two children would each have received one-third of Betsy's estate--a substantial difference!!

Most states recognize that both adopted children and posthumous children(those born after a parent's death) are due a full child's share of a parent's estate. Illegitimate children are due a full child's share of the mother's and the mother's blood relatives estates. If paternity can be proven, they are also due a full child's share of the father's estate.

Half-brothers and sisters (siblings who share only one parent in common) are treated differently in different states. In some states they are recognized as receiving full child's shares of their parents' estates whereas in other states they are given only half portions of the full child's shares.

4.10 Passing of Property by Escheat

If there are no living blood relations to the decedent and no heirs as defined by the state's intestacy laws, the decedent's property ESCHEATS to the state. This means the property is absorbed by the state. Heirs can contest the state's right of escheat. However, different states have varying time lines for when such a challenge must be made.

4.11 Who May Contest A Will

If there is a question of the validity of a will or heirs question the disposition of property outlined in the will, they may contest it. Only heirs and blood relatives to the decedent may challenge the validity of a will.

4.12 Grounds for Contesting A Will

There are various reasons why a will may be deemed invalid:

- ◆ If it can be proven that the decedent was not of sound mind when he/she made the will
- ◆ If it can be proven that the correct number of witnesses were not present or some other legal formality was not observed when the will was made
- ◆ If it can be proven that the will was a forgery (for instance if a holographic will is in a handwriting which is clearly not that of the decedent)
- ◆ If it can be proven that there was a later will written which revoked the will in question or if some legal restriction revoked the will in question (i.e.. the decedent had remarried and not made a new will)
- ◆ If it can be proven that the will was made while the decedent was under the influence of someone's forceful wishes

If a will is deemed invalid and there is a previous will, that will can be used for probate under the assumption that it contains many of the decedent's wishes. If there is no other will available, the estate property will be distributed according to the Intestacy laws of the state.

5 Elements of A Trust

Let us examine the basic elements of a trust: the GRANTOR, the TRUSTEE, the BENEFICIARY/IES; the PROPERTY, (technically called the CORPUS or RES) and the TRUST AGREEMENT.

5.1 The Grantor

The GRANTOR is the person, corporation, or legal entity which establishes the trust. The major requirement of the GRANTOR is that he/she legally own the property which is being placed in trust. He/she must also be of the legally required age to enter into a valid contract.

5.2 The Trustee

The TRUSTEE is the person(s) or entity responsible for the management of the trust property. The trustee must have the legal capacity to hold title to the trust property. The trustee can be a close friend, a relative, a bank, a trust company, or the trustee can be all of the above serving as joint

trustees. The grantor himself/herself can even choose to be the trustee of the estate though this action will not result in the kind of tax advantages that are gained if the trustee is separate from the grantor.

5.3 The Beneficiaries

The BENEFICIARIES are the persons or organization or charity or entity who will benefit from the assets of the trust. The beneficiary /ies can be under legal age. The only requirement of the trust is that all beneficiary/ies be specifically named and, therefore, identifiable.

5.4 The Trust Property

The TRUST PROPERTY is called the CORPUS or RES (hereafter we will refer to it as the CORPUS). The corpus is the property placed in trust by the grantor, either during his/her lifetime or upon his/her death (by will). Many states require a minimum corpus in order to form a trust. However, a trust can be formed using a life insurance policy as the corpus. In this case, the policy is held in trust and, upon the death of the grantor, the settlement from the policy is managed according to the terms of the trust agreement.

5.5 The Trust Agreement

Legally, there must be a written TRUST AGREEMENT in order for a trust to be considered valid (some states allow oral trusts but only under specific circumstances). The specific terms of the trust must be clearly stated. The grantor, trustee, beneficiary, and corpus must be designated in this agreement. Also, the grantor may state the purpose of the trust and specify how he/she wishes the trustee to carry out his/her duties and responsibilities. This agreement is essential as it will guide the trustee in managing the trust once the grantor is no longer available to give such guidance.

5.6 How to Select A Trustee

The careful SELECTION OF THE TRUSTEE is crucial when setting up a trust. In essence, the estate owner is choosing someone or some entity to take legal ownership of and prudently manage a portion of his/her property. Though the temptation for many people would be to choose a close relative or intimate friend whom one can trust, the estate owner should seriously consider the responsibilities this person will have and whether or not they can live up to them.

The trustee must have the knowledge and experience to manage property which may be very complex in nature. Perhaps the corpus includes real estate, such as an apartment complex which must be kept occupied. Or perhaps the corpus includes a business which must be run, or stocks and bonds which must be invested and guarded. Will the trustee your client chooses have the investment expertise or the fiduciary accounting ability to be able to wisely manage the corpus of the trust?

Also, close friends and family members will find it difficult to be impartial in managing a trust. Actions they take may provoke family feuds. Is this really the scenario your client has in mind when he/she sets up a trust meant to protect his/her family?

For these varied reasons, a bank or trust company may be the best choice for trustee of your client's trust. Aside from having the financial know-how to prudently manage the trust corpus, an institution has longevity that an individual might not have. While an institution will be around to manage a trust for many years (barring its dissolution), individuals may die before the trust terminates. Trusts can be established to continue as legal entities indefinitely. There may be consolation in knowing that as long as the trust is operative, there will be a trustee (the institution) to operate it.

If the client wishes, he/she can appoint joint trustees or co-trustees. In this case, the client can appoint an individual who is intimately connected with the family and therefore understands the real needs of the beneficiary/ies and the client can also appoint a legal entity, such as a bank or trust company, to work in collaboration with this individual. If there are multiple trustees, the grantor must establish how decisions will be made (whether by majority or not) in the trust agreement.

5.7 Duties and Powers of A Trustee

The DUTIES OF THE TRUSTEE provide for the responsible management and administration of the trust property for the benefit of the beneficiary/ies. The primary loyalty of the trustee is to the beneficiary/ies. The trustee is required to be accountable to the beneficiary/ies by keeping accurate records and by rendering periodic accountings of the corpus of the trust to the trust beneficiaries. This accounting includes the responsibility of the trustee to file appropriate tax documents and, in the case of testamentary trusts, to submit required accountings to the probate court.

In general, the trustee is wholly liable for his/her prudent management of the trust. By law the trustee is bound to the prudent person rule which requires the trustee to manage the corpus by making judgements and acting as any prudent person would. Indeed, if the trustee is accused of mismanagement of the trust, he/she can be held personally liable for the losses suffered.

Therefore, while the trustee is expected to manage the trust as if it were his/her own property--wisely and prudently--he/she is expected to understand that all action taken regarding the property is meant to benefit only the beneficiary; the trustee is forbidden to mix his/her own personal funds with those of the trust.

Because the trustee is personally liable for the prudent management of the trust, he/she must have certain POWERS or AUTHORITY granted by the grantor through the trust agreement in order to execute his/her duties. Some of these powers are specified by law; others are outlined in the trust agreement.

For example, generally a trustee is not allowed to continue a business held in trust or mortgage trust property. If, however, the grantor wishes the trustee to have the authority to enact either of these transactions, he/she can so specify in the trust agreement.

Also, the trustee may incur certain reasonable and necessary expenses in his/her execution of his/her duties towards the trust. In such a case, he/she has the authority to cover these expenses using trust assets. It is imperative that an attorney who understands the complexity of laws regarding trusts be engaged to draw up the trust agreement.

5.8 Fiduciary Responsibility of the Trustee

In order that the beneficiary/ies receive the fullest benefit from the established trust, the trust agreement must be thorough--foreseeing any possible eventuality.

Though the trustee is personally liable to the trust beneficiary/ies for any mismanagement of the trust assets, generally, this liability only applies in cases where deliberate fraud or negligence can be proven.

For instance, if it can be proven that the trustee passed up an investment that would have been extremely beneficial to the trust assets out of sheer negligence and therefore caused a substantial loss to the trust assets, the trustee would be liable to cover the loss and reimburse the trust.

5.9 Types of Trusts

Trusts can either be created during the lifetime of the grantor, called INTER VIVOS TRUSTS(also LIVING TRUSTS), or upon the death of the grantor, called TESTAMENTARY TRUSTS.

TESTAMENTARY TRUSTS

TESTAMENTARY trusts are trusts which are established upon the death of the grantor through the terms of the will. Testamentary trusts do not provide substantial savings to the estate. Though the estate owner may save on attorney's fees in preparation of the necessary documents (the testamentary trust and the will are one document as opposed to the two documents needed to establish a living trust--the trust and the will) the assets in a testamentary trust are considered to be owned by the grantor during his/her lifetime and therefore are subjected to both income taxes during life and estate taxes after death.

Also, because the testamentary trust is established through the will, if the will is successfully contested and the decedent is determined to have died intestate, the trust will never come into existence.

INTER VIVOS OR LIVING TRUSTS

The INTER VIVOS or LIVING trust, on the other hand, can provide some shelter from taxes and therefore can be a valuable tool in the total estate plan. There are two types of LIVING TRUST: the REVOCABLE TRUST and the IRREVOCABLE TRUST.

REVOCABLE LIVING TRUST

The terms of a REVOCABLE LIVING TRUST allow the grantor to revoke or amend the trust agreement at any time during his/her life. Such flexibility enables the grantor to change his/her mind about who is to be the beneficiary of the trust or how the trust will be administered.

For instance, George and Helen could establish a revocable living trust early in their marriage, designating a trustee and setting terms for the trust agreement. As they age, they may become less able or willing to manage the assets of the trust themselves and may wish to change the terms of the agreement to allow the trustee more responsibility. Or, they may divorce and wish to revoke the trust altogether, making the trust funds available for division and distribution.

Because the grantor never completely gives up rights to property in the revocable living trust (he/she can always revoke the trust and regain access to the property) assets are considered to be owned by the grantor and therefore continue to be taxed under income tax if they earn income.

However, a major advantage to the revocable living trust is that the trust assets don't go through probate when the grantor dies. Therefore, though the grantor will not necessarily save tax expenditure on the trust assets during his/her lifetime, his/her estate will save substantially on estate taxes making this type of trust a valuable estate planning tool.

IRREVOCABLE LIVING TRUST

If an estate owner wishes to save both income taxes and estate taxes, he/she may consider establishing an IRREVOCABLE LIVING TRUST. Appropriately named, this trust is irrevocable--once property has been placed in it, the terms of the trust cannot be amended and the trust assets cannot be regained.

The advantage of this type of trust is that, because the property is no longer considered to be owned by the grantor, its income is not taxed as grantor's income and it is not subject to estate taxes upon the death of the grantor.

However, in order to qualify for these tax exemptions, the grantor gives up the right to amend or revoke the trust, indeed to stipulate in any way how the trust should be invested or how the trust property should be used by the beneficiaries. Also, the grantor can in no way benefit from the assets of the trust--for example by paying premiums for life insurance on his/her life using trust income.

It is important to note that an irrevocable trust is considered to be a gift, according to the tax code, and by setting up this type of trust, your client may be making a taxable gift. The tax code of the state in which the trust is being created should be consulted to determine whether gift taxes will be owed upon the creation of such a trust.

5.10 Benefits of Setting up a Trust

As we have indicated, there are many advantages to setting up trusts. Some of the BENEFITS are summarized below:

- ◆ Though there are no tax benefits to setting up a testamentary trust, an estate owner can avoid estate taxes by creating a revocable living trust. Also, he/she can avoid both estate taxes and income taxes by creating an irrevocable living trust--though he/she may find that gift taxes will

apply.

- ◆ The creation of certain types of trusts can protect estate assets from creditors of beneficiaries. Depending upon the stipulations of the trust agreement, the trust assets are safely set aside and cannot be distributed indiscriminately. Even if a beneficiary has thousands of dollars of debt and a trust fund worth \$100,000, unless the trust agreement stipulates otherwise, those debts cannot be paid in full using the trust money and therefore depleting the fund. The beneficiary will only receive income from the trust as stipulated in the trust agreement. In this way, the grantor can reach out to a beneficiary after death and encourage wise fiscal management.
- ◆ Because the corpus of the trust is managed by a trustee(or trustees) who is presumably financially competent and prudent, the assets are protected from mismanagement and eventual depletion. Minor beneficiaries or beneficiaries who may not be capable of handling assets prudently will not be able to squander the property set in trust. This can prevent fortune hunters from targeting innocent beneficiaries of inheritances or heirs from spending their inheritances unwisely and too quickly.
- ◆ Most importantly, unlike a will, which is on file in the probate court and thus available for the public to read, a trust agreement is a strictly confidential document, the terms of which only need be known by those immediately involved.

5.11 Duration of the Trust

The DURATION OF TRUSTS established for charitable giving is unlimited. A grantor is allowed to create a trust in perpetuity to benefit a college, museum, church, etc. However, if a trust is established for specified individual beneficiaries, those same beneficiaries must be allowed to take possession of the trust property no later than 21 years after the trust was established. If one of the beneficiaries is conceived but not yet born at the time the trust is established, an additional nine months can be added to this time frame. If the beneficiaries are not allowed to take control of the property within this time frame, the trust will be deemed invalid.

In general, the duration of a revocable trust runs from the creation of the trust and the duration of an irrevocable trust runs from the point of death of the grantor.

Though the rule against perpetuity demands that the trust property be vested to the beneficiaries within 21 years, the trust can remain in existence for as long as is necessary. A trust established for a mentally incompetent person may need to last 50, 80, 100 years or more. There is no rule that determines the overall life of the trust.

5.12 Disposition of the Trust

No matter which type of trust is established, part of the terms of the trust agreement will stipulate how the trust corpus is to be distributed to the trust beneficiary/ies. If the corpus includes income-producing property, there are several ways in which that income can be paid out.

In a SIMPLE TRUST, all earned income is paid out in full. In a COMPLEX TRUST (also called ACCUMULATION TRUST), income is allowed to accumulate. A DISCRETIONARY TRUST (also called SPRAY or SPRINKLING TRUST) allows the trustee the discretion to distribute the income as he/she sees fit. If the grantor retains the power to access trust income and therefore is considered the owner of the trust according to the rules of income taxes, this trust is called a GRANTOR'S TRUST.

While some trusts are created in such a way that only the income is meant to be distributed and the trust capital is meant to remain intact, other trusts are created in such a way that the capital itself, as well as the income it produces, may be distributed to the beneficiary/ies.

Perhaps an estate owner wishes to buy a life insurance policy in an amount that will pay off his/her mortgage on his/her home when he/she dies, leaving his/her spouse with one less financial worry. This estate owner could put this policy in a trust which would pay out the entire principal to the spouse when the policy comes due. Upon the death of the estate owner, the spouse would then have the immediate capital necessary to pay off the mortgage on the home and own it outright.

If the grantor authorizes the trustee to pay out the entire principal of the trust, the trust is then

terminated upon payment. Another option is for the grantor to authorize the trustee to pay out a percentage of the principal at intervals of time, always maintaining a base percentage of the principal in the trust.

Any number of options are available for disposition of both the trust principal and the trust income. However, it is absolutely essential that the estate owner work with an attorney skilled in drawing up trust agreements so that every detail of how the trust should be managed is specifically outlined and clear to the trustee. With proper planning, the TRUST can be an immensely effective estate planning tool.

6 Insurance Trusts

There are two types of INSURANCE TRUSTS: the PERSONAL INSURANCE TRUST and the BUSINESS INSURANCE TRUST.

6.1 The Personal Insurance Trust

The PERSONAL INSURANCE TRUST is created by a grantor to benefit individuals or institutions. There is no provision made, in this type of trust, for any business interests of the grantor. Personal Insurance Trusts may be FUNDED or UNFUNDED.

A FUNDED Personal Insurance Trust is one into which the grantor has placed sufficient funds to pay the policy premiums out of the trust. In the case of a Funded Personal Insurance Trust, the trustee is responsible for making policy premium payments and can be held liable if he/she fails in this duty.

An UNFUNDED Personal Insurance Trust can be created with no specific funds, using the life insurance policy as the trust corpus. Because there are no funds available in the trust, the trustee is not responsible for paying the premiums on the life insurance policy. In this case, the grantor is the responsible party and he/she must ensure that policy premiums are paid.

Personal Insurance Trusts are useful tools in estate planning as they allow the grantor to consolidate his/her many various insurance policies into one trust so that, upon his/her death, the assets of these various policies can be treated as one and managed in a comprehensive, cohesive way.

Furthermore, the grantor of this type of trust can specify in the trust agreement flexible terms of distribution of funds allowing the trustee to respond to the changing needs of the beneficiaries of the trust over a long period of time. In some cases, the flexibility of trust distribution is preferable to settlement options offered in life insurance policies.

For instance, if an estate owner dies leaving a \$500,000 life insurance policy to his wife, payable in one lump sum, she may not feel capable of managing such a sum of money. On the other hand, if the estate owner establishes a Personal Insurance Trust using this policy as the corpus, when he dies, the \$500,000 becomes the principal of the trust and the trustee manages and distributes the money according to terms previously stipulated by the grantor.

In the above example lies another benefit of the Personal Insurance Trust over a simple life insurance policy. If a trust is established, a trustee is appointed to administer the trust. This trustee will be an individual with sound financial judgement and knowledge about the investment of assets. Often, the beneficiaries of life insurance policies are members of the decedent's family who may not be sophisticated in financial matters. The importance of having a trustee handling the inheritance of the beneficiaries as opposed to leaving them to struggle on their own cannot be stressed enough.

Lastly, the Personal Insurance Trust can save the estate owner from depletion of assets upon the settlement of the estate. If the life insurance policies of the estate owner are payable to the beneficiaries of the estate directly, creditors of the estate may attempt to place claims against the funds as the estate is being settled. With the policy safely tied up in a trust, the financial security of the beneficiaries is secure because the funds will only be able to be released according to the terms

of the trust agreement.

6.2 Business Insurance Trusts

BUSINESS INSURANCE TRUSTS are trusts created to allow for the continuation or disposition of a business interest so that both the business and the decedent's family benefit upon his/her death. By using a Business Insurance Trust, an estate owner can ensure that a business interest which he/she has spent a lifetime building won't fall to ruin upon his/her death.

This type of trust may be established by the business or by individuals (the business owners, for example) but its sole purpose is to benefit and/or safeguard the business interest of the estate owner (as opposed to the Personal Insurance Trust which is meant to benefit individuals or institutions such as charities).

A Business Insurance Trust can be established to protect the business against the loss of a key person, such as the president or one of the partners. In this case, the business would buy a life insurance policy for a specified amount on the life of this key person. The business would use this policy to establish a Business Insurance Trust specifying that upon his/her death the policy would be payable to the trust which would then put the money back into the business. In this way, the business would have time to recover the loss of income formerly provided by this key person and regain its financial stability after his/her death. In this case, the business would pay the premiums on the policy.

Such a trust could also be established to buy out the interests of the estate owner upon his death, especially in cases where no one in his/her family has the interest or ability to continue the running of the business. In such a case, the business would take out the same policy on the estate owner's life and establish a Business Insurance Trust with it. However, upon the death of the estate owner, the business would take the funds paid out from the insurance and use them to buy out the estate owner's former interest in the business, thus allowing the remaining business owners to continue the operation of the business unhindered by the family's interference. (This type of arrangement can provide the funding for the buy/sell agreement which was discussed in Unit Two)

The major advantage of the Business Insurance Trust is that it allows the estate owner to plan for the disposition or continuation of his/her business and know that his/her plan will be carried out by the trustee. Because the trustee is usually an impartial third party, he/she can objectively execute the wishes of the estate owner even if these wishes cause family feuding or misunderstanding.

Also, as the estate owner has had the time to adequately plan for the future of his/her business with an estate planner and to draw up a trust agreement which executes these well-laid plans, upon the settlement of the estate his/her beneficiaries will get the most benefit from this business interest .

6.3 Elements of an Insurance Trust

When the trust agreement is drawn up for an Insurance Trust, there are several elements of the agreement which must be addressed. These are: **THE RIGHTS OF THE INSURED**, **THE TRUSTEE AS BENEFICIARY**, and **THE TRUSTEE'S RESPONSIBILITIES**.

THE RIGHTS OF THE INSURED

In the case of a **REVOCABLE LIVING INSURANCE TRUST**, the grantor of the trust owns the insurance policy set in trust and therefore has certain rights of ownership concerning the policy. These are called the **RIGHTS OF THE INSURED**.

He/she has the right to choose a policy dividend option, to take out loans on the policy and to assign the policy or name a beneficiary of the policy. However, it may be necessary to specify certain limitations on these rights in the trust agreement to avoid putting the trust itself at risk.

For example, an insurance trust has been established by a business to buy out George's interest in that business after his death. Thinking he will live a very long time, George exercises his right to borrow against the value of the insurance policy in order to pay for his son's college tuition. Suddenly,

one day, he dies of a heart attack. He has never repaid the policy and the business is left without his vital contribution and without the assets to buy out his interest. George's son, who knows nothing about the business, uses the interest he now owns in the business to try to control its operations. The business begins to fail and within six months is forced to close. The funds from the sale of this business interest were to be the sole support of George's widow and now she has no income.

The situation described above could have been prevented had limitations been put on George's rights as the insured. In order for the trust to do what it was created to do, very specific instructions must be detailed in the trust agreement.

Note that a life insurance trust can be created as irrevocable. In this case, the trustee is assigned all rights and interest to an insurance policy and the grantor of the trust has no rights to amend or change the trust or the insurance policy.

THE TRUSTEE AS BENEFICIARY

Though in a revocable living insurance trust the grantor is also the policyholder and the insured, the TRUSTEE of the trust is actually the BENEFICIARY of the policy. The trust is created to benefit the beneficiaries of the estate. In order to avoid probate taxes on the income from the life insurance policy, the policy is paid into the trust--not the estate.

Because the trustee is legal owner of the trust property, he/she is named as the beneficiary of the policy. When the policy comes due, the funds go through the trustee into the trust and are distributed according to the trust agreement to the beneficiaries.

The estate owner must name the trustee as beneficiary to the life insurance policy. He/she can do this by purchasing new insurance and naming the trustee as the beneficiary of this insurance or by assigning the trustee as beneficiary to an existing policy.

THE TRUSTEE'S RESPONSIBILITIES

The TRUSTEE's RESPONSIBILITIES are outlined in the trust agreement created by the grantor of the trust/estate owner. One of the more important of these responsibilities is to collect the funds due from the insurance policy upon the death of the policy owner. Should the death be deemed suspicious and the insurance company hold back payment, the trustee has the responsibility of pursuing the claim in court.

As we have mentioned, insurance trusts can be REVOCABLE or they can be IRREVOCABLE.

6.4 Revocable Insurance Trusts

A REVOCABLE LIFE INSURANCE TRUST allows the grantor to control the assets of the trust during his/her lifetime. The grantor also has the right to revoke the trust, to change the terms of the trust agreement and to regain the legal right to the trust property. As we mentioned in the Unit on Trusts, because the grantor retains access to the property in trust, he/she is liable for income taxes on this property. However, the trust property does not go through probate, upon his/her death.

This kind of trust is particularly useful if a grantor owns property in another state. If this property is in trust when the estate owner dies, it will not have to go through probate in the state where it exists. However, the revocable trust is very common because it gives the grantor such flexibility.

6.5 Irrevocable Life Insurance Trusts

The IRREVOCABLE LIFE INSURANCE TRUST is often used to pass assets on to another generation so that the grantor can avoid present income taxes and future estate taxes. Because the nature of an irrevocable trust is that the grantor gives up all rights to and control of the trust property, there are no income taxes nor estate taxes imposed on the assets of the irrevocable life insurance trust.

The irrevocable trust is usually created when the grantor places life insurance policies in the trust as a gift. The grantor then continues to gift funds to the trust which can be used for the payment of the

life insurance policy premiums.

One of the major tax advantages of the Irrevocable life insurance trust is that funds placed in this type of trust avoid income taxes. However, they are only excluded from income taxes because these funds are considered gifts to the trust. As long as these gifts can be considered gifts of present interest and fall within the amount allowable by the revenue service, they will be eligible for gift tax exclusion.

In order to be considered gifts of present interest, the trust must annually offer withdrawal privileges to each of its beneficiaries. This privilege is called the Crummey withdrawal (named for the person who was first involved in a lawsuit regarding this type of trust) and the trust is called a Crummey Trust. When a grantor creates a Crummey Trust, he/she assumes that the beneficiaries will decline their right of withdrawal in the interest of the ultimate purpose of the trust.

Obviously, if there is no Crummey withdrawal privilege established in the trust, then the gifts to the trust are gifts of future interest (to be used at a future time when the grantor dies) and would not qualify for the gift tax exclusion thereby making the trust less useful as a tax saving tool.

If the Irrevocable Life Insurance Trust is a Crummey Trust there are certain requirements which must be met in order for the estate owner to receive the best tax advantage from the trust. These requirements include the RIGHT TO WITHDRAWAL and the responsibility of WRITTEN NOTIFICATION.

The right to withdrawal simply means that each time a contribution is made to the trust, the beneficiaries of the trust must have the right to withdraw an amount equal to their share of the gift, thus qualifying the contribution as a gift.

Written notification means that the trustee must make the offer of withdrawal right to the beneficiaries of the trust, giving them a date by which they must exercise this right. If they do not respond by this date, it is assumed they have declined their right to withdraw funds.

Though it is assumed that the beneficiaries will never exercise their right of withdrawal, the formality of the offer and the rejection must be attended to.

When considering TAX ADVANTAGES of the Irrevocable Life Insurance Trust, it is important to keep in mind the following:

- ◆ The trust assets will only be considered a gift of present interest and therefore be eligible for the gift tax exclusion if the Crummey withdrawal privilege is written into the trust agreement.
- ◆ If the Crummey withdrawal privilege is not part of the trust agreement and the trust asset is considered a gift of future interest, the life insurance policy will be subject to gift tax based on its interpolated terminal reserve value and not its actual face value.
- ◆ If the grantor makes a gift of an existing life insurance policy to a trust within three years before his/her death, the trust assets payable upon his/her death will be included in his/her estate and will be subjected to estate taxes.

One way to avoid this possibility is for the estate owner to avoid purchasing a policy which he/she then gifts to his/her trust. Instead, he/she should make a gift to the trust in the amount needed for the trust to purchase the policy. In this way, the estate owner avoids ever having owned the life insurance policy and this policy can never be considered part of his/her estate in the matter of estate taxes.

6.6 Generation Skipping Trust

In some cases, an estate owner may wish to transfer property and/or assets to his/her son or daughter to be used ultimately by that child's children. If this property is transferred through two generations, it will generally be taxed twice. In order to avoid double taxation, many estate planners recommend the GENERATION SKIPPING TRUST.

This trust was first established to allow the transference of assets to a generation at least two levels

younger than the grantor while still allowing the intervening generation some benefits from the property without the payment of estate taxes. In recent years, the government has made this kind of trust less beneficial by imposing federal generation-skipping transfer taxes. Also, some states impose their own generation-skipping tax. However, certain exemptions to the federal tax continue to make this type of trust an effective tool of the estate planner.

The \$1-million-per-transferor exemption allows the grantor up to \$1 million of generation skipping exemption to be used for transfers to grandchildren or to trusts which contain assets that will eventually pass to grandchildren.

Another exemption allows a grantor to transfer assets in the form of a gift to a grandchild tax-free when the intervening generation (the grantor's child and grandchild's parent) is deceased.

The tax implications of this type of trust are varied and the tax code complex so it is wise to consult an attorney who is very familiar with this type of trust when determining whether or not it will be a useful tool in your client's estate plan.

7 Other Estate Planning Devices

We have examined the basic nature of the trust agreement and particularly the use of insurance trusts in estate planning. There are, however, many other types of trusts and various other financial tools which may be used in the continuing effort to avoid possible future depletion of a client's estate.

As with many other estate planning tools, it is advisable to consult an attorney knowledgeable about trust laws and who can work with you and your client in order to achieve the most solid and beneficial estate plan.

7.1 The Marital Deduction Trust

In order to understand the MARITAL DEDUCTION TRUST it is first necessary to review the UNIFIED CREDIT. This credit was created by the federal government in order to offset the federal gift or federal estate tax of each citizen. At death, every U.S. citizen is allowed to pass on an estate of \$600,000 or less without paying any federal estate taxes on it. It's that simple. There are no strings.

However, when planning an estate, you do want to make full use of this credit--for both spouses--for it allows a couple to pass on \$1.2 million in assets tax free if they use the credit wisely.

For example, if one spouse has an estate worth \$450,000 and the other has an estate worth \$750,000, it would be wise for the spouse with the larger estate to transfer assets to his/her spouse's estate during his/her lifetime. By doing this, each spouse would have an estate valued at \$600,000. Assuming the estate's remained at the same value, if either spouse dies, he or she will not be liable for any estate taxes and, essentially, the \$1.2 million estate can be passed on to the heirs intact. (This assumes that on the death of the first spouse, the \$600,000 estate was put into a trust to benefit the surviving spouse--leaving the surviving spouse with a \$600,000 estate and a \$600,000 trust.)

The MARITAL DEDUCTION, in turn, allows spouses to leave an unlimited amount of assets to each other completely tax free. The assets are considered a gift or bequest to the surviving spouse and the estate owner is allowed to deduct 100% of this gift, thus avoiding federal estate taxes. The marital deduction is only allowed on qualifying property.

In order to qualify, property must provide a lifetime of income to the surviving spouse and he/she must have the right to choose how the property will be disposed of upon his/her death.

Also, his/her interest in the property can not terminate due to the passage of time and can not be tied to the occurrence of some event (for example the interest couldn't be withdrawn if the surviving spouse remarried).

Given the simplicity of the marital deduction, it may seem like a good idea for a husband to leave his wife everything when he dies so that she and his family will avoid the federal estate taxes. However, in this type of estate plan, when the wife dies, the estate will then be heavily taxed because she won't be able to take the marital deduction.

Example: If George has an estate worth \$5 million, he can transfer all of his assets to his wife, Joan, upon his death and she will pay no estate taxes. However, if Joan is not capable of managing this estate in such a way that it is protected from taxes when she dies, it will be heavily taxed at that time. When she dies, she will qualify for the Unified Credit for the first \$600,000 of estate assets but the other \$4.4 million will be taxed at the highest federal estate tax rate. Had George split his estate before he died--planning for its disposition so that he could avoid shrinkage--he could have also qualified for the Unified Credit. Here's how: George could have split the estate into two parts--one would go to Joan upon his death; the other would establish a \$2.5 million trust which could provide for her during life but which would avoid probate at her death. Upon his demise, the \$2.5 million that Joan inherits is tax free because of the marital deduction. The \$2.5 million which establishes the trust is taxed minus the \$600,000 unified tax credit so only \$1.9 million is subject to estate taxes. When Joan dies, the \$2.5 million estate which she inherited tax-free from George is now taxed but minus the \$600,000 so only \$1.9 million is taxed. In this scenario, a total of \$3.8 million in assets is taxed for both estates as opposed to the \$4.4 million in assets which would have been taxed in the earlier example had George not split the estate. This type of planning is called ESTATE SPLITTING. It makes the best use of the Unified Credit and the Marital Deduction.

A variation on the ESTATE SPLITTING principal is the A-B LIVING TRUST (also called the marital deduction and unified credit trust). In this arrangement, instead of leaving half of the estate directly to the surviving spouse, the assets are placed in an A trust that qualifies for the marital deduction. (In order to qualify for the marital deduction, the A trust must be completely controlled by the surviving spouse and must provide that spouse with a trust income in annual or semi-annual installments.)

The B trust (also considered the deceased's trust or the family trust) contains the remainder of the estate after all bequests, taxes and expenses have been paid. The B trust makes use of the decedents unified tax credit.

The A trust will make use of the surviving spouse's unified tax credit upon his/her death. Along with the trust the B trust provides benefits to the surviving spouse for life. However, as part of the trust agreement, the B trust will ultimately benefit the children following the surviving spouses death, without having to go through probate as part of his/her estate.

The Q-TIP TRUST (Qualified Terminable Interest Property) is another form of trust making use of the marital deduction. This type of trust allows the grantor to side-step the marital deduction rule that requires the surviving spouse to control the ultimate disposition of property given using the marital deduction. Instead, the grantor can leave a terminable interest in trust to the spouse.

This means that a spouse could leave his/her spouse interest in the trust with the specification that the principal of the trust would go to their children upon the death of the surviving spouse. This deprives the spouse of the right required by the marital deduction to control the disposition of the trust at his/her death. This type of trust bears special requirements and should be handled by an attorney familiar with its particularities.

7.2 Survival Clauses

An often unconsidered eventuality is the simultaneous death of both spouses. Most states have a Uniform Simultaneous Death Act which declares that each spouse is considered to have survived the other with respect to his/her own property. Obviously, this act deprives both spouses of using the marital deduction to reduce estate taxes. There are two clauses which can be used in wills to lessen the damage created by this legality.

The reverse simultaneous death clause merely reverses the states declaration. It states that in the event of simultaneous death, one spouse (the one with the smaller estate) is to be considered the

survivor of the other. This allows the spouse with the larger estate to be considered the first deceased and therefore to use the marital deduction in transferring his/her estate to the surviving spouse. Without this clause, the larger estate would go through probate twice and pay double estate taxes.

The six month survival clause is of particular use when there have been several marriages. It requires the surviving spouse to survive for a specified period of time (not to exceed six months). If he/she dies during this period, the marital deduction is lost and the spouse who was first to die will be allowed to pass his/her property to whomever he/she chooses rather than it having to pass through his/her spouse's estate. If the surviving spouse survives this period, the marital deduction applies and he/she receives his/her bequest.

7.3 Grant or Retained Income Trust (GRIT)

The GRANTOR RETAINED INCOME TRUST (GRIT) is an irrevocable trust which allows the grantor to retain interest in the trust property for a specified period of time after which time the trust property passes to the beneficiary. This type of trust is especially useful when dealing with property/assets which will increase in value.

The tax advantages to such a trust are complex. Because the grantor retains interest in the property, he/she is taxed on that income during his/her lifetime. If he/she is still living when the specified period of time ends, he/she loses interest in the trust and the property is no longer considered an asset of his/her estate. This means that when he/she dies, this property will be excluded from probate.

However, if he/she dies before the specified period of time, he/she is considered to still have interest in the trust property and it will be included in probate.

The GRIT is established when the grantor makes a gift of future interest to a beneficiary of the trust--for example, he/she may set a valuable piece of real estate in trust. Because the gift is of future and not present interest, it will be subject to the gift tax but not until the gift is vested to the beneficiary.

As long as the grantor has interest in the trust corpus, the gift tax doesn't apply. When the grantor dies or completes the specified time period, then the gift is made and the gift tax paid. However, the tax is substantially decreased because under the time-value money principles, the value of the right to receive property in the future declines as the waiting period increases. Often, the unified credit will be large enough to shelter the taxable gift when it comes time for the beneficiaries to be vested.

Normally, a personal residence is used as the trust property in a GRIT. If a widow/er is left with a residence of substantial value which may continue to increase in value and he/she needs tax shelter for the estate, he/she may place the residence in a GRIT. This will allow him/her the use of the residence (say, for perhaps 10 years) then its value will be gifted to his/her heirs thus avoiding estate taxes on it. If he/she continues to wish to live on the property, he/she can establish a lease with the trust and pay the trust rent.

Two other kinds of Grantor Retained Interests Trusts are the GRAT (Grantor Retained Annuity Trust) and the GRUT (Grantor Retained Unitrust). As opposed to allowing the use of property as the GRIT does, the GRAT provides the grantor with an annuity. This annuity is an irrevocable right of the grantor granted by the trust agreement. It is a fixed sum which must be paid annually or semi-annually from the trust. The GRUT provides the grantor with a unitrust interest from the trust. This interest is determined by taking a percentage of the annual fair market valuation of the trust.

Obviously the tax advantages of the Grantor Retained Interest Trusts are greatest when the grantor survives the period of interest specified in the trust agreement thereby allowing his/her interest to be transferred to the trust and to avoid probate and estate taxes.

7.4 Pour Over Trust

The POUR OVER TRUST is another valuable estate planning tool. This is a revocable trust set up during the estate owner's lifetime. It stipulates that after the estate is settled and all debts and liabilities paid, any remaining estate assets will pour over into the trust and be managed according to the trust agreement. The practicality of such an agreement is that an estate owner can combine various assets

from life insurance, pension plans or employee benefit programs into one trust which can be administered efficiently.

7.5 Grantor Trusts

GRANTOR TRUSTS were originally created to shift taxable income from the grantor to the beneficiary. They were irrevocable trusts which had built into the trust agreement a reversion of the trust property back to the grantor for specified reasons.

Two common types of grantor trusts were the CLIFFORD TRUSTS and the SPOUSAL REMAINDER TRUSTS. The Clifford Trust required that the grantor keep the property in trust to the beneficiary for at least ten years before it could revert back to him/her. The Spousal Remainder Trust gave the spouse the power to revoke the trust.

However, in 1986, the tax code changed. The new code required that the grantor of this type of trust would be subject to tax on the trust income as long as there is a greater than 5% probability that the trust will revert to the grantor or to the grantor's spouse.

The major exception to this rule is in the case of a trust created in such a way that the trust will only revert back to the grantor or to the grantor's spouse if the beneficiary (who must be a lineal descendent of the grantor) dies before age 21.

Another exception allows the grantor reversion right if the trust is to last 32 or more years. Thus, a grantor could establish this type of trust upon a child's birth for a period of 32 years after which he/she could take control of the trust income again. Under this exception, income in the trust would be shifted to the beneficiary for those 32 years, giving a tax advantage.

7.6 Testamentary Trusts

A TESTAMENTARY TRUST is merely a trust set up in the grantor's will. Remember that assets in a testamentary trust must go through probate so this type of trust will be subject to estate taxes. Also, if the will is deemed to be invalid, the testamentary trust will not come into existence.

7.7 Support Trust

SUPPORT TRUSTS are trusts which are set up specifically for the support of the beneficiary--usually a minor or an elderly person--often because they are incapable or unwilling to handle their financial concerns on their own.

SECTION 2503 TRUSTS FOR MINORS are created when the grantor wishes to make a gift of future interest to a minor but also wishes to receive the advantage of the gift tax deduction on this gift. This type of trust requires that the property and its income are available to be used for the benefit of the beneficiary before age 21; that at age 21 the beneficiary be allowed to take full control of the property unless he/she agrees to let the trust continue; and that any property remaining in the trust at the beneficiary's death (prior to age 21) be payable to the beneficiary's estate or to his/her named beneficiary of the trust.

7.8 Flower Bonds

FLOWER BONDS are very special U.S. Treasury bonds so named because they blossom at death. They are issued at a discount but may be redeemed at their full value in payment of federal estate taxes. As an immediate source of liquidity for the estate which can be used to pay one of the larger debts the estate will incur, these bonds are a valuable part of the overall estate plan.

7.9 Charitable Remainder Trust

When an estate owner has property which will substantially appreciate in value (such as real estate or stock) and he/she wants to sell this property but doesn't want to pay capital gains tax now or estate

taxes later, he/she can set up a CHARITABLE REMAINDER TRUST.

Upon the creation of this type of trust, the asset is placed in an irrevocable trust naming a charity/ies as trust beneficiary. The trust agreement allows the trustee to sell the trust property, avoiding capital gains tax, and to reinvest the profit in an income-producing property which will continue to be tax-free.

The trust agreement also stipulates that the grantor (and his/her spouse and family if so desired) will receive an income for life. When the grantor (and anyone else receiving income as stipulated in the trust agreement) dies, the trust assets are payable to the charity as beneficiary.

This type of trust is a great tax saver. The grantor saves capital gains tax on the sale of the property, income tax on the income he/she receives from the trust over the years, and estate taxes on the value of the property which is no longer in the estate.

On top of these many advantages, the grantor also can be eligible for a charitable income tax deduction if the trust is set up while he/she is alive. This deduction is based on the actuarial value of the charity's interest --or how long it can expect to wait to receive this interest. This type of trust is meant to encourage the estate owner to put property in trust for the benefit of charities.

7.10 Private Annuity

The PRIVATE ANNUITY is yet another valuable estate planning tool in that it can significantly reduce both the income taxes and the estate taxes of an estate owner. A private annuity is an agreement between a property owner and a buyer that the buyer will receive the property in exchange for his/her promise to pay the seller an annuity for the rest of his/her life.

This agreement can also cover the seller's spouse, ensuring that he/she will continue to receive the annuity even after the death of the original property owner. This arrangement allows the estate owner an income tax advantage because he/she is not taxed for capital gains upon the sale but is, instead, taxed on the annuity income over the years of its dispersal, thus deferring a large tax payment. The private annuity also saves on estate taxes as once the estate owner sells the property, it is no longer in his/her estate and will not be taxed upon death.

However, a large drawback to the private annuity is that in order for it to qualify for the estate tax benefits, the buyer's promise to pay the annuity must be unsecured. If it were secured, the agreement would be considered a retained life interest under the tax code and the property would be included in the seller's estate upon death.

Because the arrangement should thus be made between parties who trust each other a great deal and have a personal stake in the transaction, private annuities are most often used within families where the property would have been gifted to the heirs anyway. By using property to set up a private annuity within a family, the estate owner can save substantially on taxes and the heirs will inherit more of the value of the property intact.

For example: Mary owns a large piece of land in an area which will very soon be developed. Because of this, the land is appreciating in value. Mary has a grown child, Janet, whom she would like to benefit from this land value. However, she fears her estate taxes may shrink the actual inheritance Janet will receive from this land. She arranges a private annuity between herself and Janet. Janet takes ownership of the land and is taxed for it in her income tax bracket and Janet agrees to pay her mother, Mary, a lifetime annuity. When Mary dies five years later, Janet has received full value of the land losing no percentage to estate taxes and paying only five years of annuity payments.

7.11 Installment Sale

Another tax saving tool for the estate planner similar to the Private Annuity is the INSTALLMENT SALE. This arrangement allows the seller of property to accept payment of the property in installments from the buyer over a period of several years, thus allowing the seller to spread the tax debt resulting from the sale over the same time period.

The seller has the flexibility to accept no payment the first year and several payments over several following years or one payment at the sale and several payments following. The arrangements vary.

The major tax advantage is that the seller can put off paying the full tax debt for a later time when perhaps he/she is in a lower tax bracket--AND he/she has the use of the tax dollars for investment until such a time as they come due.

7.12 Deferred Compensation

DEFERRED COMPENSATION is an agreement between an employer and employee which allows a highly paid employee to defer a certain part of his/her immediate earned income for receipt at a later time such as upon death, disability or retirement.

This arrangement can be particularly useful in avoiding present income taxes, deferring tax payment on the income to a time when the employee may be in a lower tax bracket (after retirement, for instance).

Deferred Compensation can exist as a QUALIFIED PLAN or as a NON-QUALIFIED plan. Both plans must be in writing between the participants. However, the qualified plan must comply with federal law provisions of discrimination and must be filed and approved by the IRS in order to qualify as tax-deductible contributions and tax deferred investment growth.

The non-qualified plan is not restricted by federal laws and as such does not qualify for tax deductions or tax deferments. The only tax advantage is that the employee with such a plan defers paying income tax on the deferred income until he/she receives it upon retirement, death or disability.

Because the non-qualified deferred compensation is more flexible, it is more widely used in estate planning. It can be tailored to each employee by an employer and is under no guideline restrictions.

However, except under certain circumstances, the sum of money which has been deferred will be considered as part of the employee's estate should he/she die--whether or not he/she has collected the full sum upon death. Because the deceased employee is considered to have an enforceable right to future benefits, these benefits will be subject to estate taxes.

An exception to this is the DBO (DEATH BENEFIT ONLY) plan, also called the SURVIVOR'S INCOME BENEFIT PLAN (SIBP). In this type of deferred compensation plan, the employee gives up all right to the deferred benefits during his/her lifetime but turns them over to his/her estate to be used for the benefit of his/her survivors. In this case, the employer agrees that, if the employee dies before retirement, the employer will pay a specified amount to the employee's spouse (or other survivor).

Because the employee has no present interest in the benefits of this plan, these benefits may be exempt from estate taxes. Because the primary reason for establishing this type of deferred compensation plan is for the benefit of the survivors, the DBO is often funded with a life insurance policy.

7.13 Installment Payments of Estate Tax

A possible consideration for aid in paying federal estate taxes due upon death is the IRS Tax Code Section 6166 which allows INSTALLMENT PAYMENTS OF ESTATE TAX. By law, federal estate taxes are due in full within nine months of death. They must be paid in cash--with no exceptions--which often causes liquidity problems for the estate. Under Code 6166, the executor of the estate could choose to pay the taxes due from interest in a closely held business (sole proprietorship, partnership, or corporation) in installments. The Code allows the executor to pay only the interest on the unpaid balance for the first four years then, for the next ten years, he/she must pay on the principal and the interest.

However, in order to qualify, the business interest must be part of the gross estate and must have a value which exceeds 35% of the adjusted gross estate. Remember, only taxes due on the business

interest qualify for this deferment. Taxes due on any other portion of the estate are due within the regular time frame. And, the executor will still need cash on hand to pay state estate taxes, funeral costs, debts, administration expenses and cash bequests left to beneficiaries. Also, unless heirs will agree to be held personally liable for the payment of taxes during the deferral period, the estate will have to remain open until all payments have been made. This means portions of the estate will be tied up and not available to beneficiaries for a long time. This may prove to have a damaging effect on those left behind.

Lastly, interest on the unpaid tax is compounded daily. Because of this, the longer tax payment is deferred, the more the IRS gets. If the estate planner and estate owner can amass enough estate tax free life insurance which the executor invests upon maturation to create a situation where income on the estate's investments exceeds the interest and principal payments on the unpaid tax then this type of deferment can be extremely beneficial to the estate.

8 Gifts

A gift of property is irrevocable so an estate owner should carefully examine his/her estate assets and determine that gifting certain assets will benefit the estate rather than leave it weakened. Property that is likely to appreciate in value is an ideal choice for gifting. By giving this property to a potential heir or family member who may be in a lower tax bracket than the estate owner, he/she saves on present income taxes and future estate taxes.

Another benefit of gifting property is that the estate owner can be assured that the beneficiary he/she chooses actually will receive the property. Because wills can be contested and thrown out, an estate owner can never be sure that what he/she wishes will be carried out after death. If he/she gives the property to the beneficiary before he/she dies, there can be no contest of the gift at a later date. And, the estate owner has the added benefit of watching his/her beneficiary enjoy the property.

Finally, because a gift is a private transaction between donor and donee, no one but the two involved parties need ever know that a gift was given, nor the value of this gift. Unlike a will, which is a matter of public record, a gift is a confidential arrangement and remains out of the public access.

Though essentially the legal transaction of giving a gift to a donee can be as simple as writing a check, there are two very particular cases involving the use of gifting which we should identify. These are the UNIFORM GIFTS TO MINORS ACT (UGMA) and CHARITABLE GIFTS.

8.1 Gifts to Minors (UGMA)

The UNIFORM GIFTS TO MINORS ACT allows parents to give gifts of property to their minor children. Because the children are minors, the gifts must be held for the children by a custodian until they reach a specified age (usually 18 to 21 but can be extended to 25 if necessary).

In order to qualify as a gift under this act, there must be only one custodian and one child to each gift account and the account must bear the child's Social Security number. The custodian may be a parent but this parent can receive no payment for his/her custodial duties. Also, the gift must be used only for the support and benefit of the child.

Gifts given to minor children under the UGMA are taxed subject to the child's standard \$600 deduction. So, the first \$600 is tax free; the second \$600 is taxed at the child's tax bracket and anything over this amount (\$1200) is taxed at the parent's tax bracket. However, these gifts do qualify for the \$10,000 gift tax exclusion and for the Unified Tax Credit. These tax advantages will be explained later in this unit.

8.2 Charitable Gifts

Another particular type of legal gift is the CHARITABLE GIFT. This type of gift can be beneficial not only to the donor (the estate owner) but also to the donee (the charitable organization) for just as the donor will receive income tax deductions, reduce his/her estate taxes and avoid any gift taxes, the

donee also pays no tax for receipt of the gift.

The charitable gift allows the donor to benefit a favorite charity or a cherished cause during his/her lifetime while also strengthening his/her estate plan. As with the UGMA there are certain guidelines which must be followed in order for an estate owner to receive credit for a charitable gift.

First, the charitable organization must be a qualified non-profit organization and recognized as such by the IRS.

Second, the gift must be made by the estate owner (not by a third party) and must be in the form of property, **not service**.

Third, the gift must be valued in excess of any value given to the donor. (For example, the donor buys a ticket for a dinner/dance benefit for the charity for \$1000. The real price of the dinner/dance per head is \$75.00. The donor can only consider \$925 to be his/her gift.)

Lastly, the donor must receive a receipt documenting the gift for any gift over \$5000.

The tax advantages for a charitable gift are generous. The charitable gift is not subject to the federal gift tax. Because the gift is not considered part of the estate owner's estate, no federal estate taxes will be imposed. And, the charity pays no tax for receiving the gift.

Charitable gifts also receive some federal income tax advantage but this is usually limited depending on the specifics of the gift. A knowledgeable tax attorney could advise a property owner as to the particular benefits of charitable gifts.

8.3 Federal Taxation of Gifts

There are several federal tax benefits which make gifts an attractive tool for estate planners: the GIFT TAX EXCLUSION, the UNIFIED TAX CREDIT, and the GIFT TAX MARITAL DEDUCTION.

THE GIFT TAX EXCLUSION

The GIFT TAX EXCLUSION is an annual tax credit that allows a donor to give up to \$10,000 to a donee free of gift tax. The donor can give to as many donees as he/she wishes and for each gift, the first \$10,000 will be gift tax free.

If a married couple wish to give a larger gift, perhaps \$20,000 to one of their children, they can split the gift, each giving the child \$10,000 and thus each receiving the \$10,000 gift tax exclusion. This would mean that they could give their child \$20,000 total and not pay any gift tax.

In order for a gift to qualify for the gift tax exclusion, it must be a gift of present interest (which we will remember means that the donee can enjoy the use of the gift in the present rather than having to wait for some future time to take ownership and benefit.) Gifts of future interest are subject to the federal gift tax with no exclusion. (See chart of gift tax rates)

UNIFIED TAX CREDIT

The UNIFIED TAX CREDIT is another tax benefit provided by the federal government to help alleviate high gift and estate taxes. As we have said before, upon death, each U.S. citizen is allowed \$600,000 worth of assets to pass estate tax free to his/her beneficiaries. This sum allows for a tax credit of \$192,800 (the tax on \$600,000 if one had to pay it).

This \$192,800 is a lifetime credit that can be applied to gift and/or estate taxes. It can be used on top of the annual \$10,000 gift tax exclusion however, the \$192,800 credit is a lifetime, not an annual credit, therefore it will run out if used entirely during the estate owner's lifetime. It is best to save this credit for use towards the settlement of federal estate taxes at death, if possible.

GIFT TAX MARITAL DEDUCTION

The GIFT TAX MARITAL DEDUCTION allows a spouse to gift any or all of his/her property to his/ her spouse without paying any gift tax on this gift at all. The donee must be given full ownership of the property or at least the right to receive income from the property. The donee must also be given general power of appointment with regard to the property. This means that the donee must have the power to decide who will inherit the property upon his/her death.

The advantage of a gift to a spouse is that an estate owner can transfer property out of his/her larger estate into his/her spouse's smaller estate before death and avoid future estate taxes. The disadvantage is that the estate owner gives up the right to determine who this property will eventually go to.

If the donee spouse were to remarry, this property would be part of his/her estate and may, ultimately go to his/her new spouse and then to that person's children. This scenario could mean that property belonging to the estate owner originally could, through a series of unforeseen events, end by belonging to people to whom he/she has no relation.

Gifts of over \$10,000 to any one individual or organization will be taxed by the federal gift tax unless the gift tax marital deduction or the unified tax credit are employed by the donor. These taxes apply to the estate owner giving the gift.

However, the donee is also responsible for income taxes on the income received through the transfer of property that is called a gift. The donee's income tax basis should be taken into consideration when a gift is made.

Normally, the point of making a gift, in terms of estate planning, is to transfer valuable or appreciating property from a larger estate to a smaller estate and from a higher income tax bracket to a lower income tax bracket.

It is important to note that there are some gifts (aside from charitable contributions) which are exempted from the federal gift tax. Two prime examples are gifts of tuition payments to an educational institution for a third party and gifts of medical expense payments to a medical facility or provider for a third party.

8.5 State Gift Taxes

Aside from federal gift taxes, some states impose their own gift taxes on gifts. These states are: Delaware, Louisiana, New York, North Carolina, Oregon, Rhode Island, South Carolina, Tennessee, and Wisconsin. When planning a gift in these states, it would be wise to examine the state tax code carefully. An exemption or deduction which is allowable under the Federal Tax Code may not be applicable under state jurisdiction.

8.6 Types of Gifts

Gifts can be given in various forms. They can be gifts of PROPERTY, gifts in the form of TRUSTS, or gifts of INSURANCE.

GIFTS OF PROPERTY

Gifts of PROPERTY can include PERSONAL property such as stamp collections, works of art, jewelry or automobiles. In such cases, the donor can simply give the gift to the donee. In the case of an automobile, the donor would need to give the title over to the donee. In the case of personal possessions, he/she may want to put the gift in writing.

Gifts of Property can also include gifts of REAL ESTATE. Again, the title to the property can be turned over to the donee. However, the donor also has the option of putting the property in joint names with rights of survivorship. Because the donor contributes the asset to a title of joint ownership with the donee, the donee is considered to have received a gift. However, this procedure would not be applicable between spouses.

Gifts of BUSINESS INTEREST, such as stock in a corporation, can also be given by signing over the appropriate documents.

GIFTS AS TRUSTS

If an estate owner wants to make a gift to a beneficiary but doesn't feel that the beneficiary is presently capable of competently handling the gift, he/she can put the gift into a TRUST for the benefit of the beneficiary. In order for the gift to be complete meaning that ownership of the gift property has completely transferred to the donee, the trust must be irrevocable. If the trust is revocable, then the trust itself is not considered a trust. However, any income paid out of the trust to the beneficiaries of the trust would be considered gift income once it is paid out. Also, if the donor serves as trustee of the trust and maintains the right to control the property from this position, whether the trust is revocable or irrevocable, it cannot be considered a gift.

GIFTS OF INSURANCE

Gifts of LIFE INSURANCE are probably the most ideal tool in estate planning. Unlike gifts of real estate or business interest, they require no management. The donee will receive a cash gift which can then be used or investment as best fits his/her needs. When a donor gives life insurance to a donee he/she can gift the life insurance policy, the premiums to pay the policy or the death proceeds from the policy. To gift a life insurance policy, the donor can purchase a new policy naming the donee as policy owner. The value of this gift would be based on the initial premium the donor paid to buy the policy added to any subsequent sums paid as premium payments. The donor can also gift an existing policy that has been paid in full.

In this case, the value of the gift would be estimated based on replacement cost for this policy. If the donor gifts an existing policy which hasn't been paid in full, the approximate value of the gift would be the cash value of the policy. Any premium payments made by the donor on the policy are considered gifts and are taxed as such.

As for death proceeds, the only time these benefits are considered a gift is when a uninsured policy owner names someone else as beneficiary to the policy he/she owns on a third party's life. Such would be the case if a husband took out a life insurance policy on his wife's life and named his child as the beneficiary. Upon the death of his wife, the death proceeds from the policy would be considered a gift to the couple's child. The major advantage of using a life insurance policy as a gift is that during the donor's life, the value of the gift is simply the cost of the policy itself and not the value of the proceeds that will come from that policy at death. Also, because life insurance proceeds escape probate, the proceeds from the gifted policy will not be subject to federal estate taxes.

As with all other estate planning tools, the use of gifts as part of the estate plan should be strategized with an attorney familiar with the specific tax codes applicable to your client both at the state level and at the federal level.

9 The Estate Plan

9.1 Meeting With The Client

We will begin with the first meeting with the client. An estate owner has come to you because he/she has concerns about his/her financial future and needs the advice of a professional. Estate owners come to a meeting like this with many fears and anxieties. They are here to plan for the eventuality of retirement and/or death. They will be forced to look closely at their life's earnings, to put a value on their estate, and to answer some very difficult questions about how this estate should be distributed when they are no longer around. Your financial expertise and confident manner can ease their worries and move them to action.

9.2 Evaluating the Estate

At this first meeting, you will gather as much information as you can. Using Appendix A. from Unit One, have the estate owner answer as many of the questions as possible in this visit. If there are questions which he/she must answer later, have him/her call you with the information. Or, he/she may want to take the questionnaire home and give it serious thought. There may be questions which he/she has never asked him/herself.

It is most important that you have the estate owner give you an accurate and truthful picture of his/her complete estate. As we already mentioned, there may be estate assets which the owner wishes to conceal from everyone except himself/herself. You must gain his/her confidence and learn all of the facts so that you can successfully do your job.

It is during this first interview (and perhaps during several more) that you will be able to evaluate the estate's net worth. What are the assets? How valuable is the real property? The personal property? What kind of cash does the estate owner have on hand? What kind of liquid assets? How much cash can be readily available should the estate owner die? Are there insurance policies to cover expenses such as a buy/sell agreement or death expenses? Is the estate owner a business owner and, if so, what plans has he/she made for this business? Have any plans been made at all? In terms of estate liabilities--what kinds of mortgages and loans are presently outstanding? Are they secured? If the estate owner dies, leaving a family, will payments on a home mortgage be funded? Or will the family lose the home as well as a father or mother? What kind of monthly bills does the estate owner's household have? How will these be affected after he/she dies? How will they be paid? Are there any outstanding legal liabilities, such as a pending suit, which may be able to make a claim against the estate owner's estate after he/she dies?

Moreover, has the estate owner ever considered the extremely high cost of dying? Has he/she made any arrangements for funeral expenses, tax debts on the estate, or immediate expenses for his/her survivors?

In these conferences with the estate owner, the estate planner should ask probing questions in order to get the fullest picture of the net worth of the estate. It is very important that the estate planner have a clear understanding of which of the assets in the estate are liquid and which are non-liquid. It is by identifying those places where the estate is weak financially that the planner can begin to devise a plan which will fulfill the estate owner's wishes.

9.3 Establishing Priorities

Once the estate planner and the estate owner have arrived at a clear picture of the owner's financial situation, they can establish priorities about how this estate should be distributed upon the eventuality of death.

A discussion of the short term needs and the long term needs of the estate owner's survivors may raise questions which have never arisen for the estate owner. For instance, the estate planner should encourage the estate owner to choose a guardian for his/her children on the remote chance that both parents are killed. The estate owner may have to think about the possible remarriage of the surviving spouse and how that possibility would affect his/her decisions.

It is just as important to encourage total frankness during the process of determining long term and short term needs as it was to reveal a complete financial picture. If, for instance, the estate owner has no faith in the ability of his/her spouse to handle the financial matters of the estate, he/she should say so. This should be addressed. A different person can then be chosen to execute the will and administer the estate. If the estate owner thinks his/her son is immature for his age and shouldn't be given substantial sums of money until a certain age, this situation should and can be dealt with through the establishment of a trust.

However, if the client is reticent and holds this sort of information back from the estate planner, the resulting plan will not be nearly as useful as it might have been. The estate planner may need to encourage the client to suggest possible concerns the client may have. The estate planner should draw out a complete picture of the client's concerns and hopes.

9.4 Creating the Plan: Matching Resources to Needs

The most challenging part of creating an estate plan for the estate planner comes at this point. It is matching resources to needs.

After several conferences with the client, the estate planner should have a clear idea of the client's resources and needs. It is at this point that the planner should go away and devise a plan which will allow the client to meet his needs using all of the many tools we discussed in this course.

Some of this plan will make use of tools the client already has in place. If the client has a will, for instance, the estate planner will begin with the existing document and will suggest additions to bring it up to date. If the client already has established trusts, the estate planner may want to look at them to determine whether they are giving the estate owner the full benefit of the assets in them and either recommend changes or leave them as they are.

A complete and practical understanding of the various kinds of trusts, the various tax advantages offered (such as the unified credit and the gift tax exclusion) and of other estate planning tools (like private annuities and deferred compensation) will be invaluable to the estate planner. Though he/she will not have the attorney's power to implement trusts and annuities, his/her knowledge of how these tools can best work for the estate owner will contribute to the formation of a successful estate plan.

The estate planner should be creative in his/her use of the estate planning tools. Though there are very sophisticated computer software tools designed to create estate plans, it is recommended that they be used only in combination with an estate planner's own creative thinking. Each individual estate is much more complicated than merely numbers on a spread sheet. Though an estate's resources and needs can be laid out and analyzed, the peculiarities of the estate cannot be understood so simply.

Perhaps an estate owner has a child with a disability who will require very specific financial arrangements. An estate planner should do extra research into this area of financial planning and discover new tools which can be used to conserve the estate while continuing to provide for that child's secure future.

Many estate planners find this time of creation exciting and challenging. The estate plan is a direct result of the meeting of a particular client with a particular estate planning agent. Therefore, it is very personal, which is its strength.

As the estate planner is devising this plan, he/she may want to consult with other financial advisors of the estate owner. The estate owner's attorney, accountant, and even bank officer can all provide pertinent and constructive advice.

9.5 The Presentation of the Plan

Once the estate planner has arrived at a plan, he/she will want to present it to the estate owner in person. Often, the estate owner will want to have his/her advisors with him/her at this presentation. The estate planner will present the plan to the estate owner and his/her other advisors. There may be questions, doubts, and/or concerns. Perhaps the estate owner has reconsidered some of the wishes he/she stated earlier and wants to make changes. Perhaps the attorney or the accountant has new information which changes certain elements of the plan.

The estate planner should not be concerned if the plan isn't accepted completely on the first presentation, but he/she should make a note of the requested changes and take them back to the drawing board. At this stage, he/she will revise the plan based on changes agreed upon in this meeting and will present the new plan.

9.6 Compiling the Documents

Once a plan has been devised and accepted, it must be put into action. It is at this point that the estate planner becomes a manager. He/she must compile a list of documents needed to establish the estate plan.

This list may include the creation/amending of a will, the establishment of trusts, the establishment of power of appointment, the documentation of gifts, and the establishment of private annuities. All of these will have to be handled by an attorney, but the estate planner will want to enumerate which and how many documents should be prepared. He/she will then want to communicate with the parties responsible for preparing the documents and follow up to see that they are indeed prepared and signed.

Estate planners who are insurance agents assess the estate owner's insurance needs as part of the plan. It is at this point that policies should be sold and beneficiaries determined.

9.7 Ongoing Commitment

Once all documents have been created and implemented, the plan is in place. However, this is not the time to say good-bye to the client. The remaining job facing the estate planner is one of maintenance and review. It is essential to review this carefully constructed plan with the client on a yearly basis.

Financial situations change rapidly. The client personal situation could change. The economy in which the client lives could change. The client could lose his/her job. Children could grow up and leave home. A spouse could die. Inflation could skyrocket. All of these situations would require a major reassessment of the estate plan.

It is important to understand that all of the time and energy put into the first plan is only the beginning.

The relationship which the estate planner establishes with the estate owner should be a lasting one (until one of them dies, potentially). As the client grows and his/her needs change, the estate planner should adjust the plan to meet these changing needs. The challenge for the estate planner continues, and with this challenge comes the need for continuing education with respect to planning tools, and continued creativity in meeting the client's needs.

10 Tax Facts

A financial professional does not give legal advice, he or she should also refrain from giving estate tax advice. This is best left to a trained professional. However, a financial professional dealing in estate planning matters should be conversant in general tax regulations in order to identify and convey a potential estate tax problem. The information in this unit will deal with this and other issues.

10.1 Tax Guidelines Involving Life Insurance

Generally speaking, the proceeds of life insurance are not subject to federal taxation. However--and there is always a however when dealing with taxes--the life insurance in question must meet Congress established guidelines as to just what life insurance IS in order to qualify for tax-favored status. These guidelines present the following tests for all life insurance policies issued after December 31, 1984:

1. Must meet definition of life insurance as established by applicable domestic or foreign law.
2. Must pass either the cash value accumulation test OR a guideline premium cash value corridor test.
3. And, for contracts formed on or after October 21, 1988, must conform to an amended requirement that the mortality charges upon which the policy is based are reasonable. *Reasonable* means that the mortality charges are not materially different from the charges the company will indeed impose. Mortality charges may legitimately consider the insured's medical history and current physical condition.

Before going on, let us briefly review the CASH VALUE ACCUMULATION TEST and the GUIDELINE PREMIUM-CASH VALUE CORRIDOR TEST.

The cash value accumulation test requires that the cash surrender value of a life insurance policy not exceed, at any point in time, the net single premium then required to fund a policy's future benefits.

The test defines a policy's cash surrender value without regard to policy loans, surrender charges, any terminal dividend, or any dividends accumulating at interest. The test requires the net single premium be determined at either 4 percent interest OR the rate guaranteed in the policy nonforfeiture

values, whichever is higher. Mortality charges are also calculated for the net single premium: they must not be more than the standard mortality tables specified by the Commissioner of Insurance in the applicable jurisdiction. Interest rate in determining mortality charges for the net single premium is either 6 percent, OR the contract's guaranteed interest rate, whichever is higher. The future benefits of the policy are of course the death or endowment benefits ONLY. Benefits attached to the policy by riders--accidental death, guaranteed insurability, etc.--are not included in future benefits when determining if a policy meets the cash value accumulation test.

The guideline premium-cash value corridor test has two parts, both of which a policy must meet. First, the aggregate premiums paid to date under the contract are never more than the greater of either the GUIDELINE SINGLE PREMIUM or the SUM OF THE GUIDELINE LEVEL PREMIUMS. The guideline single premium is the one-time premium necessary to fund contract benefits--in other words, the amount of a one-pay life contract premium. The guideline level premium represents an ANNUAL level premium paid over a period extending to, at minimum, the insured's 95th birthday, which would fund the policy's benefit.

Life insurance contracts which are investment-oriented may qualify for some tax-favored status. Single premium contracts must pass the tests just described in order to be accorded tax-favored status. Other policies may fall into a category known as "modified endowment contracts." Such contracts are defined in the Technical and Miscellaneous Revenue Act of 1988 as any contract formed on or after June 21, 1988, which meets the definition of life insurance under applicable domestic or foreign laws, passes the cash value accumulation test, or guideline premium cash value corridor test, but DOES NOT meet the 7-pay test.

The 7-PAY TEST requires that the accumulated sum paid under the contract at any time during its first seven contract years not exceed the sum of the net of seven level premiums needed to provide paid-up future benefits IF the policy had been constructed to be paid up at the end of seven years.

In other words, this test takes a specific policy, determines the amount of benefits payable after the policy has been in force seven years, determines the total amount of premium paid under the policy in that time period, determines a level annual premium that would furnish the same paid-up benefits after seven years, and then, if the ACTUAL premium in this SPECIFIC policy does not exceed the premium in the TEST policy, the policy passes the 7-pay test.

Because the nature of life insurance contracts has changed so dramatically in the last quarter century, it is wise to review EVERY policy owned by a client, and to ACCURATELY determine whether or not the policy is entitled to tax-favored status. If some policies are not so entitled, then they should be examined to see how best to use the resources/assets they represent for maintenance and conversion of the client's estate.

10.2 Estate Taxation of Life Insurance

Since life insurance proceeds are normally paid to a beneficiary other than the named insured, they are excluded from the insured's estate, and thus are not subject to federal estate taxes. However, there are situations in which life insurance proceeds may be included, either partially or totally, in the insured's estate. We will look at these situations now.

First of all, unless the contract meets the definition of life insurance just presented, its proceeds most definitely WILL be included in the insured's estate.

And, of course, any proceeds which are paid to the insured's estate, or for the benefit of the insured's estate, are included in that estate.

For example: Luther's Aunt Mary purchased a life insurance contract on Luther's life. Aunt Mary paid all the premiums, and she retained all incidents of ownership. She designated the policy proceeds to pay off the mortgage on Luther's house, leaving it free and clear for his wife and family. However, because these proceeds paid off an obligation of Luther's estate, they would be included in his gross estate. Note that if Luther's house is considered community property, only HIS HALF of the mortgage is considered a debt of his estate. If the proceeds pay off the entire mortgage, Then such payment

may constitute a gift to his surviving wife. It pays to look into all such complications BEFORE they create problems when death occurs.

When the insured retains INCIDENTS OF OWNERSHIP in the policy, proceeds will be included in his or her estate. Moreover, an insured does not have to retain ALL incidents of ownership. Retention of only one is sufficient for the proceeds to be considered part of his or her estate. As you know, incidents of ownership include a right to the economic benefits of the policy; a right to determine the beneficiary(/ies) of the policy; a right to an interest in the policy more than 5% of the policy's value as determined immediately prior to the insured's death.

If either the policy itself or incidents of ownership in the policy are transferred by the insured owner within three years of his or her death, policy proceeds are included in the estate.

In community property states, life insurance policies qualifying as community property will have only one-half of their proceeds included in the insured's gross estate at his/her death. This occurs whether proceeds are paid to the estate, or the insured merely retains incidents of ownership.

Life insurance proceeds are calculated by the date-of-death value: this amount is the total after any unpaid policy loans are deducted, and paid-up additions, dividends or interest due paid, as of the date of the insured's death.

A life insurance policy is property. Therefore, its proceeds may qualify for the marital deduction. Certain settlement options affect whether or not the proceeds, either partially or totally, qualify for the marital deduction. For example, if one spouse owes the other spouse a debt that is secured with a life insurance policy, and if the debtor spouse dies before the debt is paid in full, only those policy proceeds that remain after the debt has been satisfied qualify for the marital deduction. Note: It has been held that assets designated to satisfy a particular obligation may not qualify for the marital deduction. In such cases, expert advice may be required. Proceeds paid to a surviving spouse under a settlement option which allows him/her to choose the terms of payment are still eligible for the marital deduction so long as the surviving spouse MAY CHOOSE lump sum payment of the proceeds.

The fair market value of a policy is included in the policy owner's estate even if someone else is the named insured. For example, suppose that Aunt Mary (in the previous example) died before Luther, the named insured in the policy she both owned and paid for. The fair market value of policy AS OF AUNT MARY'S DATE OF DEATH would be included in her gross estate for tax purposes.

Settlement options can affect the tax exposure of life insurance proceeds. Generally speaking, proceeds paid in installments do not enjoy tax-favored status: the commuted value of these installments is included in the insured-deceased's estate.

10.3 Gift Tax on Life Insurance

Life insurance gifts are valued, for tax purposes, by their fair market value at the date of the gift. Note that only in the case of single premium or paid-up policies is there a one time gift tax exposure. In the case of an annual premium policy, the amount paid each year is a gift. Fair market value, rather than the loan or cash surrender value, is the determinant of the policy's gift tax exposure. Note that policies which have only FUTURE INTEREST value DO NOT QUALIFY for the annual gift tax exclusion. For example, Max gives his son a term policy on Max's life. This policy has no loan value, and no cash surrender value. Its benefits can only be enjoyed in the future, upon Max's death. Thus, premiums paid on this policy cannot be considered as part of the annual \$10,000 exclusion.

When one spouse gives a life insurance policy to the other spouse, the unlimited gift-tax marital deduction may apply: this deduction covers gifts of interminable interests. The entire value of the gift is deductible even when the interest the donor spouse gives to the donee spouse is terminable under certain conditions. First, the gift is a "qualifying income interest for life," which gives the donee spouse ALL income from the policy, either annually or at stated intervals; the donee spouse has complete control of the property; the donor deducts the property on the federal gift tax return. Second, the donee spouse is named in a charitable remainder trust as a beneficiary: this interest need not be for

a lifetime in order for a terminable interest to come under the gift-tax marital deduction.

Some clients for estate planning might wish to make a gift of life insurance to a charity: there are tax ramifications in such situations, and a careful study of applicable regulations should be made. The advice of a qualified tax consultant is recommended.

10.4 Taxes on Annuity Income

ANNUITIES are contracts which pay out the principal sum over a period of time, distributing both principal and interest until the principal is completely depleted. Annuities may be for a fixed sum, a fixed period, or a combination of both. Since most annuities are purchased in order to provide income during the life of the annuitant, federal estate tax laws apply only in certain circumstances. Straight life annuities are never subject to federal estate tax, since their benefits end with the death of the annuitant. Some annuities continue to pay after the death of the annuitant; in such cases, the balance still to be paid may be included in the gross estate. For example, a refund may be owed; the annuity may provide for benefits to continue to a survivor/beneficiary; or there may be a death benefit provision. In cases where the annuitant paid only a portion of the cost of the annuity, the amount of benefits proportionate to that are included in the gross estate.

When an annuity is purchased as a gift for someone else, it comes under federal gift taxation regulations. Note that if a donor makes a gift of an annuity within three years before his/her death, the annuity's value will be included in his/her gross estate. And if any incidents of ownership or a life interest had been retained by the donor, the annuity would again be included in the donor's gross estate. The rule of a 5% reversionary interest also applies to annuities: should the donor have such an interest in the annuity greater than 5% of its value immediately prior to the donor's death, the ENTIRE annuity would be included in his/her estate UNLESS a general power to eliminate that reversion belonged to the donee.

Annuities may qualify for the estate-tax marital deduction under QTIP rules.

Private annuities, while not that common, serve the same purpose as more usual kinds. A private annuity is a contract between two parties, the annuitant, who transfers cash or other property, and the payer, who makes a promise--which is usually unsecured--to pay the annuitant a lifetime income. Federal income tax regulations apply to private annuities, as do federal estate tax rules. For estate tax purposes, private annuities' value is determined by discounting future payments.

10.5 Taxation of Qualified Pension and Profit-Sharing Plans

Qualified pension plans offer tax savings from the time of their inception all the way to the death of participants and the transference of benefits to their survivors/beneficiaries. For our purposes, the tax savings we are most interested in are the income tax-free death benefits funded by life insurance to the extent of the "pure insurance" factor--i.e., proceeds minus the cash surrender value; the \$5,000 income tax-free death benefit; federal gift tax not applied to an irrevocable transfer of the right to receive death benefits provided by employer contributions.

Tax exposures for a decedent's beneficiary under a qualified plan are as follows:

When accumulated cash benefits are paid, they are taxable: how they are taxed depends upon how they are paid. If paid in a lump sum, the first \$5,000 is tax-exempt, except in the case of certain nonforfeitable rights. If they are paid as an annuity, annuity tax rules apply.

Payments made to a beneficiary as part of a joint and survivor annuity contract are treated specifically: any estate tax due to the inclusion of the contract in the decedent's estate will be deducted pro ratio over the period of the beneficiary's life expectancy. The \$5,000 death benefit exclusion does not apply to joint and survivor annuities made prior to the death. When a beneficiary receives benefits as a life annuity, that annuity must be paid in the form of a qualified joint and survivor annuity, which would result in a lifetime, not a fixed-period, annuity.

In terms of Individual Retirement Accounts, the value of the IRA is part of the owner's gross estate.

If a participant in a 401(k) plan dies while benefits remain in the account, those benefits go to his/her beneficiaries, either in a lump sum or as an annuity. Lump-sum distributions are now determined with five-year averaging.

Tax-deferred annuities or tax-sheltered annuities are used by 501(c)(3) organizations and public school boards as means to defer compensation to their employees. Death benefits under such contracts are included in the annuitant's gross estate. If an employee of a 501(c)(3) organization makes an irrevocable choice of a beneficiary or survivorship annuitant, no gift tax is due on amounts contributed by the employer. The employee may make a revocable choice that becomes irrevocable--again, this does not constitute a taxable gift. But under other tax-deferred plans, such an irrevocable choice does make the whole of the transferred interest a taxable gift. The above applies only to employer contributions. The employee's contributions are ALWAYS considered a taxable gift, when the right to benefits is irrevocably transferred to a beneficiary or survivor annuitant.

Unlike pension and profit-sharing plans that meet the requirements of Code 401, or annuity plans that meet the requirements of Code 403, unqualified deferred compensation plans are not eligible for the tax benefits qualified plans receive. Unqualified plans may select which employees participate: in qualified plans, ALL employees are eligible, though they have the choice of not participating if they wish. Many unqualified plans still must meet ERISA regulations.

Deferred compensation plans' benefits do constitute an asset which may be included in the participant decedent's estate. Payments made to the estate itself will be subject to federal estate taxation; payments made to a surviving spouse or other beneficiary will be taxed as income. The \$5,000 death benefit exclusion will apply except in cases where the employee had a nonforfeitable right to receive the amounts concerned while living. When the deferred compensation plan pays a death.

Note: In community property states, contributory pension and/or deferred compensation plans belong equally to two spouses. Thus only 50% of taxable benefits are included in the decedent spouse's estate. In cases where a plan began prior to marriage, that portion earned before the marriage would be the separate property of the participant spouse; only the portion earned after the marriage would be community property.

Employee death benefits refer to those paid by an employer to an employee's surviving spouse/beneficiary, either by contract or voluntarily. Such benefits are not included in the employee's gross estate for estate tax purposes if three conditions are met:

1. The employee had no interest in the benefits;
2. Neither the employee nor his/her estate receives any portion of the benefits;
3. The employee had no control over the agreement defining the benefits, or choice of beneficiary.

10.6 Federal Estate Taxes

One of the more difficult aspects of estate planning, in many instances, is the reluctance clients have to consider their "estate" as separate from themselves. And yet, unless they can clearly grasp this concept, your ability to help them maintain and conserve their estate is handicapped. Perhaps a copy of an estate's federal income tax form, filed after the death of the person to whom the estate once belonged, will convince clients that an estate is a legal entity with a life of its own, and must be so regarded.

Estates earn income. They incur debts. They receive interest and dividends. They can buy and sell. All, of course, at the hands of their administrators. All too often, estate executors and administrators are chosen for reasons of sentiment--"I don't want my son to think I don't trust his judgement"--than for reasons of business. Convincing clients to take an interest in the fate of their estates--these legal entities that will carry on their businesses as well as their dreams--will make your job a great deal easier, and a great deal more pleasant.

First of all, let's review what constitutes the gross estate. Essentially, the gross estate includes any

and all property in which the decedent had an interest, whether partial or total, at the time of death. This means real estate; cash and other negotiable assets; personal property; life insurance proceeds except under special conditions; joint and survivor annuity contracts for which the decedent paid in full; jointly owned and community property; property which the decedent legally controlled. The most significant point to look at when deciding whether or not a particular property will be included in the gross estate is whether or not two conditions are met: first, the decedent possessed the property or an interest in it at the time of death; second, that property or interest was transferred at the time of death.

As we have noted, gifts and other transfers of property which occur within three years before the date of death are usually included in the gross estate.

Other units have dealt with identifying an estate's assets and liabilities, and determining which available instruments can best serve to maintain and conserve the estate. Note that credit is given for gift taxes paid on post-1976 gifts, and that a further reduction is possible under the Unified Estate Tax Credit.

Under this rule, each taxpayer has a lifetime unified estate and gift tax credit. It reduces the taxpayer's tax on a dollar-for-dollar basis. The unification is accomplished by bringing adjusted taxable gifts into the estate tax base. Note that the tax credit the unification process yields can not be more than the amount of tax due. For transfers over \$10 million, a phase-out of the unified credit begins, with 5% of the tentative tax added on to the tax due until the benefit of unification is recaptured.

Except in certain instances, the federal estate tax must be paid in full when the tax return Form 706 is due--nine months after the date of death. Extensions may be granted; extensions of up to ten years can be given if the estate executor can show reasonable cause to the IRS. In certain cases, such as when a farm or closely held business interest is part of the estate, the estate tax which can be apportioned to that interest may be paid by installments. This is available only if such interest is more than 35% of the value of the adjusted gross estate. Two or more interests can be combined to make up the 35% so long as at least 20% of the value of each part of the gross estate. Also, the executor must elect to take the installment payment option.

Two points of note about the federal gift tax have been brought up again in this section: the \$10,000 exclusion and the Unified Estate and Gift Tax Credit. Normally, the \$10,000 exclusion is applied to gifts for current use. Thus, most transfers to minors do not come under this exclusion, with the exception of a 2503(c) trust. Such a trust provides that both property and income must be available to be spent either by the donee or for his/her benefit by age 21. At age 21, control over the distribution passes to the donee.

The Unified Estate and Gift Tax Credit gives lifetime shelter to gifts up to \$600,000. A direct credit is available: it is \$192,800. All adjusted taxable gifts are added back to a decedent's estate, which enlarges it when federal estate tax is computed. The appropriate unified credit is then subtracted for the tax. Note that the present interest rule, the terminable interest rule, and the partial interest rule, are not applicable to the unified credit.

11 Estate Issues and Law

In recent years, estate planning has evolved beyond the avoidance probate to the preservation of wealth. The consummate estate planner is dedicated to limiting conflicts and tax burdens that could "chip away" at this wealth. He is equally concerned with "asset depleting" issues like terminal medical problems and an inability to care for oneself long term. Then, there are certain moral considerations.

11.1 Advanced Planning

In his arsenal, the estate planner relies on many protection tools: insurance, trusts, wills, strategic titling of property and much more. These are discussed throughout this book. Underscoring everything, however, is the need for **advanced planning**.

For example, when the time arrives that a person has slipped into unconsciousness by the grip of a terminal disease or gradually deteriorated to advanced stages of Alzheimer's, it will be too late to make personal choices as to who will be in charge of medical decisions, finances and other moral issues. A conservatorship may be the only option.

A **conservatorship** is a legal arrangement whereby another person is authorized by the courts to oversee the personal care and property of an adult considered incapable of managing alone.

Conservators can be limited to specific tasks like health care only, finances only etc.

Instead of drastic measures like conservatorship, it would be preferable for a person to make his or her own choices for an overseer. That is why "advanced thinking" legal and financial planning professionals recommend everyone draft a durable health care power and durable financial power.

The **durable health care power** authorizes another person to make medical decisions for a person who is unable to do so. Typically, these documents "spring" into action when a person becomes incapacitated. Some people prepare these documents to prevent artificial means from keeping them alive when their wishes are otherwise. These documents can help greatly in situations where family members may disagree on "pulling the plug".

A **living will** is somewhat similar with the exception that a person's wishes are directed to medical personnel, whoever they may be. However, living wills only take effect when a person has an incurable and irreversible condition diagnosed by two or more physicians and has no effect if the patient is pregnant.

Similar to the health care power, a durable power of attorney for finances can "spring" into action when a person is considered incapable of managing on his or her own. The person given the authority to act on behalf of another is called an "attorney-in-fact". Typically, they would handle property and finance decisions like paying bills, making deposits, collecting insurance, etc.

Advanced planning logically extends to the preparation of wills, trusts and, of course insurance.

11.2 Asset Protection

An increasing emphasis by estate planners involves the tools and concepts surrounding asset protection. The idea of using legal vehicles to head-off economic catastrophes has more chance to grow than ever before. Face it, despite an insurance agent's best efforts to provide safe, appropriate levels of coverage, out country's expanding liability policy guarantees that something will be missed along the way. Just think about the thousands of legal decisions made each year based on **precedents**. Each legal precedent sets the stage for the next step of expansion. This, coupled with the willingness of judges and juries to allow this expansion established uncertainty and a whole new round of claims we could only imagine.

Current asset protection planning is designed to "plug the holes" insurance fails to cover. Gaps such as punitive damages or gross negligence, exposure beyond policy limits, new and exotic environmental liabilities and even a client's inability or forgetfulness to pay premiums. Some think of it as "doomsday planning" but every asset protection attorney has an arsenal of horror stories about smart and financially secure people who purchased insurance yet lost everything over a technicality or an unforeseen claim beyond the scope of the policy.

Their solution is a combination of sophisticated "tinting" strategies like Nevada corporations with matching "lines of credit", family limited partnerships, off-shore trusts, etc, designed to make a potential creditor or plaintiff stop and think . . . perhaps opening the door to a more reasonable settlement of the differences at hand.

The essence of this legal tinkering is the assumption that "**the whole is worth more than the sum of its parts**". Therefore, an estate that is divided into many small parts is less attractive to pursue

than a nice, fat estate with commonly titled assets.

Good attorneys will be the first to admit that these measures may provide mere “roadblocks” in front of potential creditors . . . nothing is foolproof. These measures are reinforced, however, when asset protection is treated like a vaccine, not a cure. And like most vaccines, for best results it should be started early, before the illness (lawsuit / claim) strikes while the legal waters are calm. Critics also point to volumes of law known as **fraudulent conveyance** which can void a transfer of property if it is done without adequate consideration and with intent to avoid creditors.

11.3 Inheritance

A person has a choice in determining who can inherit his or her property. Without clear, written instructions, state law determines how property will be distributed.

When one thinks of inheritance documents, wills and trusts immediately come to mind. There are, however, other ways to directly pass property to loved ones, including joint tenancy titling, beneficiary CD's, beneficiary type vehicles and trusts.

11.4 Probate

The Superior Courts are typically given jurisdiction by the state constitution over all matters of probate and administration of estates.

The "probate court" is no more than a department of the Superior Court. Probate proceedings may be either domiciliary or ancillary. If a person dies and leaves property in more than one state, administration proceedings may be necessary in each state. The original proceedings are typically brought in the state where the deceased person lived, and accordingly are known as **domiciliary proceedings**. The proceedings in other states where property is found are known as **ancillary proceedings**.

Despite best intentions of writing wills and using probate-avoidance devices like living trusts, most estates still require a probate since there always seem to be property to distribute that has been contested or left out of specific instructions.

As a matter of fact, property left through a will cannot be transferred to beneficiaries without passing through probate.

Probate is very costly and time consuming --about seven months (longer for complicated estates) and about 5 percent or more of the value of the estate.

Ways to avoid or minimize probate include the use of living trusts, holding title in joint tenancy, designating a beneficiary on all bank accounts ("in trust for . . ."), life insurance and annuity proceeds and other beneficiary type funds like IRA's, Keogh's, etc,

A major probate is also avoided for all property that is left, without restriction, to a surviving spouse. All that is necessary is for the surviving spouse to submit an affidavit for community property real estate (40 days after death) and a Spousal Property Order. If no one objects, the court approves an official transfer of ownership to the surviving spouse. This process takes about one month.

11.5 Wills

A valid will can be made by anyone who is 18 years or older. The best method is to type, date and sign in front of a witness. A will designates what should be done with property and who will do it at the death of its author. A will can also designate a guardian to care for minor children left behind.

The person designated by will to be in charge of the estate is called the **executor**. The executor is charged with the following duties: acquiring certified death certificate copies, inventory the deceased assets, find beneficiaries, notify benefit agencies (social security / medicaid/medi-cal), collect insurance

proceeds, file tax returns, pay debts, transfer properties and handle probate.

One issue that surfaces at death, even where a will is involved, is **marriage property rights**. In community property states, each spouse legally owns half of the marriage property acquired during marriage and is free to leave it to whomever he or she pleases without claim by the remaining spouse. Separate property may also be left to a beneficiary other than the spouse.

What happens in a common law state or when a spouse is inadvertently omitted from a will because a person forgot to change his will after marriage? To protect the surviving spouse, the law allows what is called a statutory share or an **elective share right**. In essence, this permits the surviving spouse to claim the deceased spouse's share of separate property. If the deceased intentionally indicated a wish to disinherit a marriage partner by saying so in a will, the "statutory share" claim could be blocked.

Minor children may inherit up to \$5,000 worth of property without any special arrangements. Over this amount, however, a guardian must be appointed. If this is not specified in the will, the court will appoint one. Ways to avoid a court-appointed guardian include the following:

- ◆ Designate an adult in the will
- ◆ Designate a guardian for the children and a custodian for the money
- ◆ Create a child's trust and designate an adult to run it

11.6 Death Without A Will

If there is no will and no executor designated, the court will appoint an **administrator** who has the same duties as an executor. Typically, the surviving spouse is the first choice, then the children. Without a will (intestate), property of a deceased is usually distributed as follows:

The **surviving spouse, if any, inherits all community property and 1/3 of the separate property** if there are surviving children and other close relatives. The remaining 2/3 of separate property goes to these children and relatives. If only a spouse and children survive, the separate property is divided equally. For unmarried people, surviving children inherit all: If none, the relatives.

To inherit property from a deceased person who has no will, the person who is in line to inherit must survive the deceased for at least 120 hours.

CONFIDENTIAL ESTATE PROFILE

Name
 Spouses Name
 Address (Home)
 Address (Business)
 Phone (Home) (Business)
 How long at the above address?
 Previous address? How Long?

FAMILY PROFILE

<u>Name</u>	<u>DOB</u>	<u>Occupation</u>	<u>Special Needs</u>	<u>Support Needed</u>
Husband				
Wife				
Child				
Child				
Child				

Husband's Family

<u>Name</u>	<u>Age</u>	<u>Resides</u>	<u>Net Worth</u>	<u>Support Needed</u>
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Father
 Mother
 Brothers
 Sisters

Wife's Family

<u>Name</u>	<u>Age</u>	<u>Resides</u>	<u>Net Worth</u> <u>Support Needed?</u>
Father			
Mother			
Brothers			
Sisters			
Other Dependents			

Is Husband a US Citizen? If not what citizenship does he hold?
 Is Wife a US Citizen? If not what citizenship does she hold?
 Date and place married, divorced, widowed:
 Any former marriages? Are you paying alimony? Child Support?

Your social security number:

Your spouse's social security number:

Are both husband and wife covered by Social Security?

Date of last Social Security review?

Do you have a will? When was it last revised/written?

Does your spouse have a will? Last revised/written?

Have you named guardians for your children? Whom?

Do you have a pre- or post-nuptial agreement?

Have you created a living trust? Who is the trustee?

Who are the beneficiaries?

Has your spouse created a living trust? Who is the trustee?

Who are the beneficiaries?

Have you or your spouse ever made a gift under the Uniform Gift to Minors Act?

Who is the custodian? Who are the donees?

Are you or any members of your immediate family beneficiaries of a trust? If so, who?

Do you or your spouse expect to receive gifts or inheritances? If so, who? How much?

From whom?

Have you or your spouse ever given any gifts in excess of \$10,000? To Whom? When and how much?

Did you serve in the military? If so from to

Any benefits from service?

Did your spouse serve in the military? If so from to

Any benefits from service?

FINANCIAL PROFILE

Professional Consultants for Financial and Business Planning:

<u>Name</u>	<u>Address</u>	<u>Phone</u>
Attorney		
Accountant		
Trust Officer		
Other Bank Officer		
Life Underwriter		
Property/Casualty Agent		
Investment Advisor		
Family Doctor		
Business Partners and Advisors (If business is owned)		

List below all property you currently own excepting life insurance or business interest. State whether you own it outright, as community property, or as joint ownership (give percentage you own). Be sure you include all real estate, securities, mortgages owned, accounts receivable, personal property (inventory your household, jewelry, collections), royalties, patents, copyrights, and cash in bank accounts.

List below all life insurance policies. Give the name of the issuing company, the policy number, the issue date and the amount of coverage. Who is the owner of these policies? Who are the beneficiaries? What is the cash value? What is owed? List all policies for both spouses. Do you have health insurance? State whether it covers disability income and conditions of coverage. Give the hospital, surgical and major medical coverage on the policy. What are the monthly payments on this policy (if you pay them yourself)?

Give your annual income including any income not already covered in this questionnaire.

Do you live on a monthly budget?

How much?

How much do you save annually?

In what form? Why?

How much do you invest annually?

In what form? Why?

How much do you think you should be able to save and invest annually?

For what?

Which of the following are priorities for you? List in order of rank:

A comfortable retirement? Financial security in the event of a long-term disability? College education for children? Care of your survivors in the event of your death? Other?

Regarding the above question, how do you estimate the cost or benefits which those priorities will require? List each item of priority and how much you estimate needing to meet the priority.

What Liabilities do you currently have? List all loans or debts. Give creditors, amount due and whether the debt is insured and/or secured.

Do you intend to make any special bequests, including to charities?

Have you made funeral and burial arrangements?

Does someone know what they are?

Is your spouse good at handling money?

If left on his/her own, would your spouse's judgment or emotional stability serve the best interests of the family?

How emotionally mature are your children?

Have you appointed an executor, trustee, or administrator for your estate? If so, whom?

Detail in what manner you would like your estate to be distributed.

Business Interest

Full Legal Name

Phone Number

Address

What type of business is it? (Proprietorship, Partnership, Corporation?)

What year did it begin operation?

Date of incorporation, if different than the above?

Employer ID number:

What is your role in this business?

Do you have an employee contract?

List all owners and what percentage of the business each owner has?

Do you want your business interest retained or sold if you retire? Become disabled? Die?

If Retained, who will own your interest and how will he/she acquire it?
 Who will replace you in your job?
 If sold, who will buy your interest?
 How will the price be determined?
 How will the buyers pay for it?
 Is there a legal agreement confirming all of the above?

Your Employment

Who is your employer?

What benefits are provided by this employer? List any employee group insurance and detail policy coverage. Is there a pension plan? An IRA plan? A tax-deferred annuity plan? A deferred compensation agreement? A stock option? A Death Benefit Only plan? List all applicable benefits and detail their coverage.

Now that you have thoroughly defined your estate, use the worksheet below to arrive at a rough estimate of the net worth of that estate.

<u>ASSETS:</u>	<u>Value</u>
Real Property	\$
Personal Property	
Bank Accounts	
Business Interests	
IRA's	
Securities	
Trust Property	
Retirement Benefits	
Insurance	
Annuities	
Other Assets	
<i>TOTAL ASSETS</i>	
<u>LIABILITIES</u>	<u>Debt</u>
Mortgage	\$
Notes	
Installment Loans	
Charge Accounts	
Business Debts	
Insurance Loans	
Other Liabilities	
<i>TOTAL LIABILITIES</i>	
<u>NET WORTH</u>	
Subtract liabilities from assets to get total net worth	\$